

If COVID is bad for developed countries, it must be worse for frontier ones, right... Right?

By Andrew Brudenell & Edward Evans

A successful investment in Frontier Markets requires foresight, patience and timing. However, the effort is well rewarded. Investors need only reference Emerging Markets meteoric rise and accompanying stellar stock market performance when they underwent a similar early stage development.

A function of their success though, Emerging Markets no longer play the same role in a global portfolio and instead are much more entwined with global capital sentiment and flows. Frontier Markets have taken their place as one of the most compelling ways to boost and diversify the risk adjusted returns for a global portfolio.

The perception that if COVID is bad for developed countries it must therefore be worse for frontier countries, is unsubstantiated. This is true whether one looks from a societal, macroeconomic or policy perspective. Frontier Markets recent lagged price performance is therefore not commensurate with the fundamental reality on the ground. Investors should grasp opportunities to exploit such market overreactions with both hands to benefit from the compelling long term case for investment.

The second wave of Emerging Markets

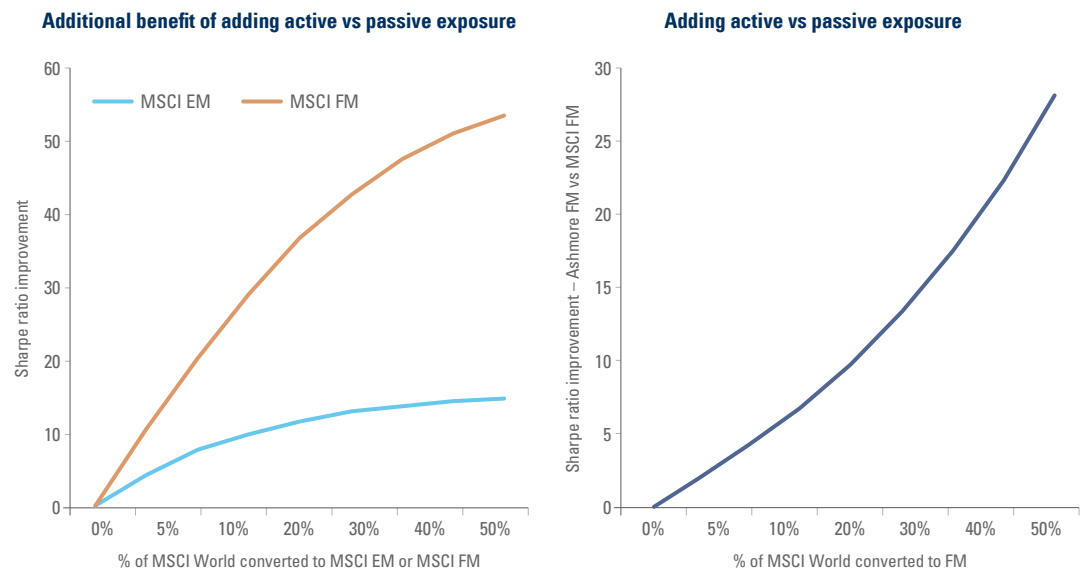
Frontier Markets (FM) is a catch-all title that encompasses Africa, Middle East as well as global Frontier Markets including small Emerging Markets (EM). Their investment rationale is compelling.

In brief, the addition of dedicated FM exposure to existing EM mandates can:

- 1] Enhance portfolio returns given FMs structurally higher return characteristics which are driven by underpenetrated economies and often oligopolistic market structures.
- 2] Exploit significant market inefficiencies given their under researched nature.
- 3] Increase diversification to a portfolio given FMs low correlations and domestic driven return drivers that are less reliant on global macro drivers and flows.

Fig 1: **Sharpe ratio improvement by adding FM to a global portfolio**

Adding FM to a global portfolio can meaningfully enhance risk adjusted returns



Source: Ashmore, MSCI.

LHS chart: Calculated by reducing MSCI World allocation and adding either MSCI EM or FM based on data from 31 May 2002 to 31 December 2019.

RHS chart: Reducing MSCI World and adding Ashmore FM composite (gross of fees) instead of MSCI FM. Based on data from 31 December 2014 to 31 December 2019.

FM's strong performance potential

Analysing and attributing FM's strong performance potential though is not as straight forward compared to more developed markets. For example, FM indices mislead since their returns are not replicable, in part, given high levels of index reclassification over time. This is evidenced by ETFs' meaningful underperformance to the index they seek to track, even if compared to more liquid index versions. In the case of MSCI FM, the UAE, Qatar, Pakistan, Argentina and soon to be Kuwait (at 37% of the index!) have all been reclassified to MSCI EM since 2014. These reclassifications cause significant market distortion. Indices also suffer from excessive concentration and regional bias.

The severe failings of FM indices led us to change our reference index at the beginning of 2020. This ensured we could provide our investors with a diversified, representable and stable map of the potential investment opportunity. Ashmore sponsors a custom MSCI FM + Select EM¹ index that is comprised of all MSCI Frontier Markets and also small Emerging Markets that we believe have 'fallen between the cracks'. These latter markets are typically <1% of MSCI EM Index and not under the systematic coverage of core EM managers. Consequently, the reference universe remains faithful to our view that a FM portfolio should be a portfolio of 'everything you do not already own' and our investment approach remains unchanged.

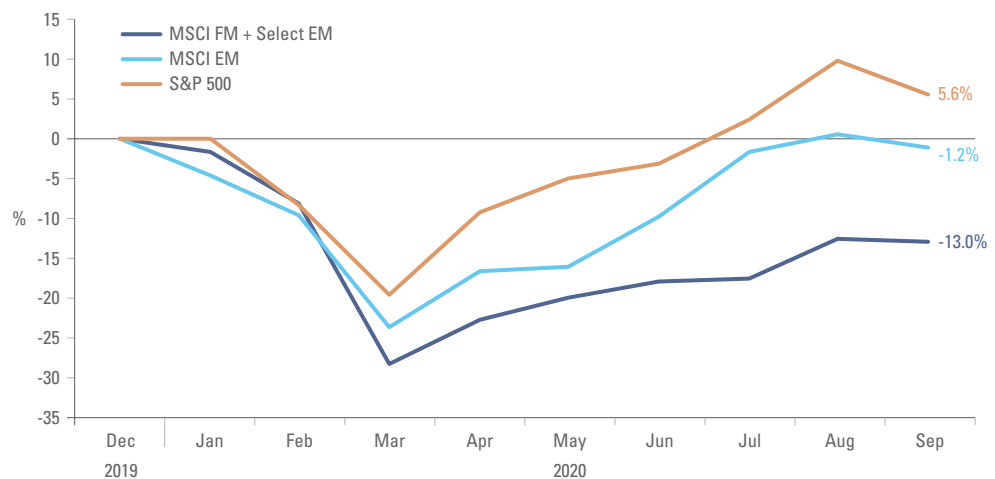
How does one assess the real performance potential of FM? The investment opportunity and potential returns are most clearly monitored by tracking an active manager that is unconstrained to an index. In our view, EM Frontier Equity Strategies should seek to deliver long term strong absolute returns in US dollars over time that are also be ahead of the 'opportunity costs'; by this we mean any FM index or the MSCI Emerging Markets Index.

If the rationale for investing in FM and how to access their benefits are apparent, the challenge becomes, how to time an investment? The answer is a combination of patience and taking advantage of opportunities when presented. We believe the current environment could prove to be an excellent case in point.

If COVID is bad for developed countries, it must be worse for frontier ones, right?

FM have undergone a meaningful and indiscriminate sell off driven by the unknowns of a global pandemic. As a typically non-core allocation in global portfolios, FM suffered more than Emerging and Developed Markets and, reflecting their less entwined nature with global capital flows, have lagged the market rebound. Is this stock market reaction warranted and a reflection of FM's greater fundamental vulnerability to the current global backdrop, or, is this an investment opportunity created by a market knee jerk reaction to a risk-off event? Let us run through a health check of FM fundamentals to find out.

Fig 2: YTD market returns



Source: Ashmore, MSCI.

FM index performance is a 'red herring'

An investment opportunity triggered by a market knee jerk reaction

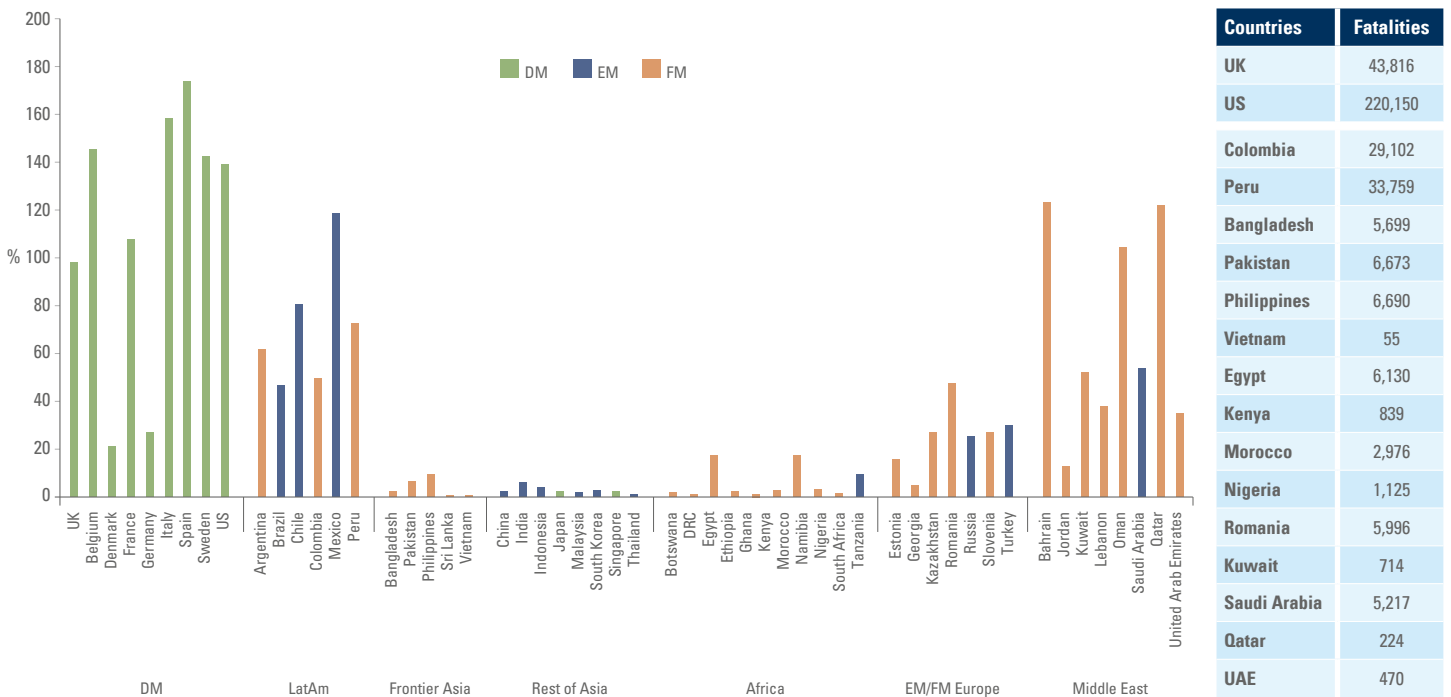
¹ The MSCI Frontier + Select Emerging Markets Countries Capped Index is a customised benchmark that is designed to measure equity market performance of constituent companies in each of the MSCI Frontiers Market Index (50%) and emerging markets crossover markets (50%), which are the Philippines, Qatar, United Arab Emirates, Peru, Colombia, Argentina, Egypt and Pakistan, together with a country cap of 15%. Please see Important information for additional information.

The shock factor of COVID is less in FM

• Societal shock

We do not believe there is a greater fundamental vulnerability to a ‘societal shock’ in Frontier Markets, than in the Emerging or Developed world. Data suggests the COVID-19 pandemic’s impact on FM healthcare systems (and hence consumer and corporate confidence, spending patterns and potential time for activity levels to recover) will be less severe than commonly perceived. The COVID-19 fatalities, as a percentage of typical annual fatalities from communicable diseases, is notably modest in the vast majority of FM cases, in stark contrast to developed markets. Where the percentages are less favourable in FM, for example Qatar, this reflects the strength of its typical track record dealing with health care matters and the absolute number of fatalities is low. In summary, in frontier parts of the world, where medical challenges are sadly more commonplace and diseases less ‘shocking’, this time is unlikely to be different.

Fig 3: COVID-19 fatalities as a percentage of typical annual fatalities from communicable diseases



Source: COVID-19 fatalities per country – Bloomberg. Data as at 20 October 2020. Annual fatalities from communicable disease – Global Burden of Disease Collaborative Network. Global Burden of Disease Study 2017 (GDB 2017), Seattle, United States: Institute for Health Metrics and Evaluation (IHME), 2018.

FM have passed the stress test reflecting significant strides towards greater institutionalisation and policy orthodoxy

• Macroeconomic stress test

Turning to the economic impact, the view also does not hold true. Typically, macroeconomic stress is most quickly evident through domestic currency volatility and weakness. Yet there has been little evidence of this in Frontier Markets. Those with USD pegs have remained credibly tied (e.g. the UAE, Kuwait and Qatar), some markets have seen FX strength compared to the US Dollar (e.g. the Philippine Peso and Egyptian Pound) while others have been stable (e.g. the Vietnamese dong). The commoditised economies of Kazakhstan, Peru and Colombia saw notable FX weakness, which is ‘healthy’ as it demonstrates their freely floating and orthodox nature, where the currency dampens commodity price volatility on fiscal balances. Nigeria is somewhat an exception where government intervention has led to meaningful divergence between the official Naira rate (as used by MSCI and Bloomberg) and the more realistic informal rate. We have been wary of this for some time now and take a prudent and conservative stance in such instances and mark-to-market where our assets have exposure to the Naira. Official and parallel Naira rates should, in time, converge and this anomaly will then be removed (either lifting our returns or reducing that of others).

FM, and world economies have just undergone one of the most abrupt and significant stress tests in recent history. In nearly every FM case they have passed this test, reflecting the significant strides towards greater institutionalisation and policy orthodoxy. This should further engender confidence with local businesses, as well as global investors, to the benefit of returns, and both ROE and equity valuations. Real GDP growth consensus expectations for 2020 are positive for a number of countries (for example, Vietnam +3%, Kenya +1%, Egypt +2% and Bangladesh +2%). This is in stark contrast to developed markets (e.g. US -4.0% and UK -9.9%).

Significantly, GDP growth expectations for global economies are generally being revised upwards as the world surprises positively in its ability to adapt to the 'new normal'. The same is happening for FM, although less efficient data disclosure can lengthen the time for this to become evident. As confidence builds that the economic impact on FM has not been as severe as initially feared, and indeed that FM have proved more resilient than developed peers, it will be a catalyst for investors to return to the asset class. This will be apparent to domestic investors before regional and international investors' catch on.

Fig 4: Real GDP growth trajectories

| Real GDP | 2020 | | | 2021 | | | 2022 | | |
|--------------|----------|------------|----------|----------|------------|----------|----------|------------|----------|
| | Current | 3 months | | Current | 3 months | | Current | 3 months | |
| | Forecast | Abs. Diff. | % change | Forecast | Abs. Diff. | % change | Forecast | Abs. Diff. | % change |
| Bangladesh | 5.0% | 2.50% | 100% | 5.8% | -0.20% | -3% | 7.0% | -0.50% | -7% |
| Vietnam | 3.0% | 0.20% | 7% | 7.9% | -0.10% | -1% | 6.7% | 0.05% | 1% |
| Egypt | 1.9% | 0.00% | 0% | 3.0% | -0.25% | -8% | 5.3% | - | - |
| Kenya | 1.0% | -0.10% | -9% | 5.5% | 0.00% | 0% | 5.5% | -0.15% | -3% |
| Pakistan | -0.4% | 0.00% | 0% | 2.0% | 0.00% | 0% | 4.0% | -0.25% | -6% |
| Kazakhstan | -2.0% | -0.65% | -48% | 3.9% | -0.40% | -9% | 3.8% | -1.30% | -25% |
| Qatar | -3.3% | -0.05% | -2% | 3.0% | 0.25% | 9% | 3.3% | - | - |
| Nigeria | -3.6% | -0.10% | -3% | 2.4% | 0.40% | 20% | 3.0% | 0.40% | 15% |
| Saudi Arabia | -4.6% | 0.30% | 6% | 3.2% | -0.20% | -6% | 3.1% | 0.15% | 5% |
| Romania | -5.0% | 0.10% | 2% | 4.0% | 0.00% | 0% | 3.7% | 0.45% | 14% |
| UAE | -5.4% | -0.55% | -11% | 2.4% | 0.25% | 12% | 3.2% | - | - |
| Morocco | -5.4% | 0.00% | 0% | 4.3% | 0.00% | 0% | - | - | - |
| Kuwait | -5.7% | -0.40% | -8% | 2.6% | 0.15% | 6% | 3.4% | - | - |
| Colombia | -6.2% | -1.50% | -32% | 4.4% | 0.70% | 19% | 3.3% | 0.05% | 2% |
| Philippines | -7.7% | -4.60% | -151% | 7.4% | 0.15% | 2% | 6.4% | 0.30% | 5% |
| Peru | -12.2% | -3.70% | -44% | 8.6% | 2.20% | 34% | 5.0% | 1.35% | 37% |

Source: Ashmore, Bloomberg, IMF, October 2020.

Growth expectations are generally being revised upwards, sometimes with a lag

FM have generally been willing and able to respond to recent challenges

• Policy stance

From a policy standpoint, one can generalise and sub divide FM into categories, although clearly there are overlaps. There are those countries and economies with ample financial resources and tools at their disposal, often with USD pegs, that can manage and finance the still fluid COVID challenge for as long as merited (e.g. Kuwait and Qatar). There are those countries that have been notably proactive in their response to COVID containment (e.g. Vietnam) and now demonstrate 'FIFO qualities'. In the case of Vietnam, COVID has also helped accelerate much needed infrastructure projects which should sustain the country's remarkable growth trajectory and investment potential. There are also those countries that have been able to source additional funding to help offset potential temporary disequilibrium in their finances, for example due to fluctuations in tourism and remittances (e.g. Egypt and Kenya). This has been possible at short notice and at amenable borrowing rates given the credibility these countries have built up with global institutions, such as the IMF and the World Bank.

• Earnings

Similar to real GDP, earnings have generally exceeded expectations. We are approaching the third quarterly release of financial results since the global pandemic took hold. During this period, the market narrative has evolved from 'no clue' to 'it's going to be bad' to 'maybe it is not so bad'. We expect the next iteration to be 'pleasant surprise'. This is, of course, a crude overgeneralisation and FM is a hugely heterogeneous universe with 'winners' and 'losers' to every situation. Overall, earnings have inflected positively and are set to overtake sentiment as the driver of market performance.

Some of the companies we own (e.g. world leading mobile money/digital payments) have only benefitted from the acceleration of existing trends in technology. Others have seen meaningful headwinds to profitability in the near term (e.g. banks), yet have proven track records of surviving and often emerging stronger from periods of crisis, taking outsized market share gains from weaker peers. Others still are the prime beneficiaries of policy measures to stimulate economies back to health (e.g. materials, industrials). Finally, there are companies that benefit from long term early stage secular step changes in consumption patterns that a temporary, if awful, pandemic is not expected to curtail (e.g. modern retail format brands).

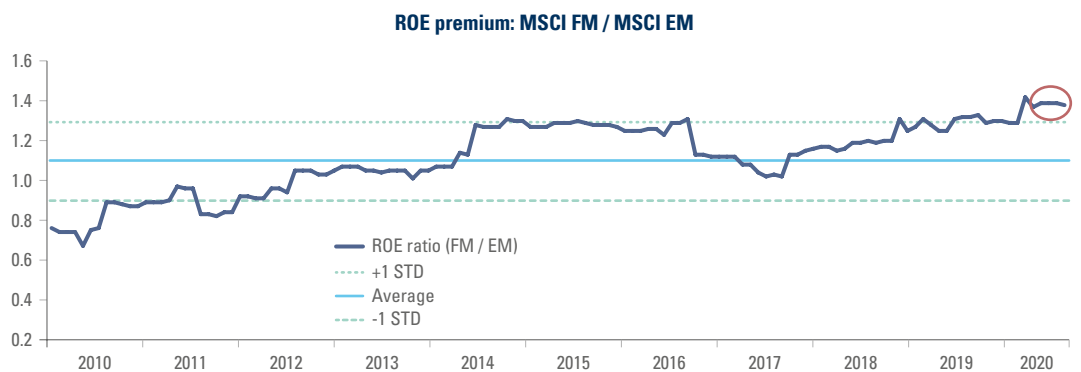
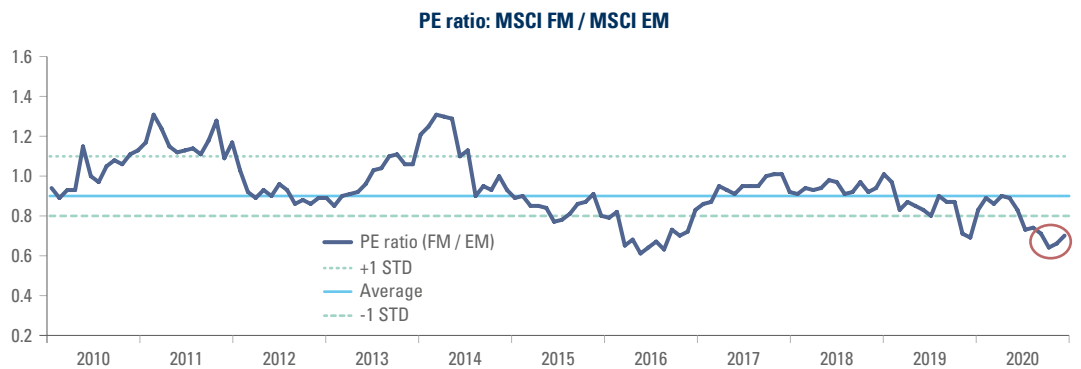
Embedded value

As all the above points separately yet uniformly show, YTD FM price performance is not commensurate with the fundamental reality on the ground. The overreaction is only more stark when one considers valuations. FM trade at historically high ROEs compared to EM (and DM) yet also at historically low price-to-earnings. On a more anecdotal basis, at a stock level there are opportunities to buy what we consider to be 'best in class' businesses at rarely seen before valuation levels.

The 'embedded value' in our portfolio is palpable given the combination of hard to access, superlative businesses with bright and profitable futures ahead. We expect the benefits of these to play out for those investors with the foresight to take advantage of the current market dislocation.

The 'embedded value' in our portfolio is palpable

Fig 5: Frontier Markets trade at valuation extremes



Source: Ashmore. MSCI. 30 September 2020.

A successful investment in FM requires foresight, patience and timing. By adding dedicated FM exposure to existing EM investments, an investor can diversify their risk return profile; gain exposure to less well understood and followed parts of the world that are undergoing rapid development; and be rewarded by potentially strong absolute returns over time. The challenge is timing, which means opportunities to take advantage of outsized market reactions should be grasped with both hands.

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