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Frontier Markets (i.e., the ones you don't own)

By Ted Smith, Ashmore Investments

Frontier Markets may be the least-understood corner of the global equity map. Investors often have little appreciation of (and no allocation to) these under-researched markets. So what are the Frontier Markets? In short, they are the ones that you probably won't find in your current Emerging Market Equity Fund. I will identify some of the reasons why that is the case and show how those are the very reasons to get interested in Frontier Markets. Despite their relatively small size and underdeveloped status, Frontier Markets represent one of the most attractive opportunities for growth and diversification available in the current global environment.

There is a common perception that Frontier Markets are the very poorest countries. Indeed, tiny Ivory Coast, with a per capita income of less than $4,000[1], is quite poor by any common standard. But the average citizen of Frontier Market Bahrain makes over $51,000 per year[2], more than the average German citizen. So, not all Frontier Markets are poor. What all Frontier Markets do have in common is that they all have one or more structural and/or technical issues that prevent investors and index compilers from embracing them as either Developed or Emerging Markets. Therein lies the opportunity. When these problems are resolved, tremendous value can be unlocked as a result, offering attractive returns to savvy investors.

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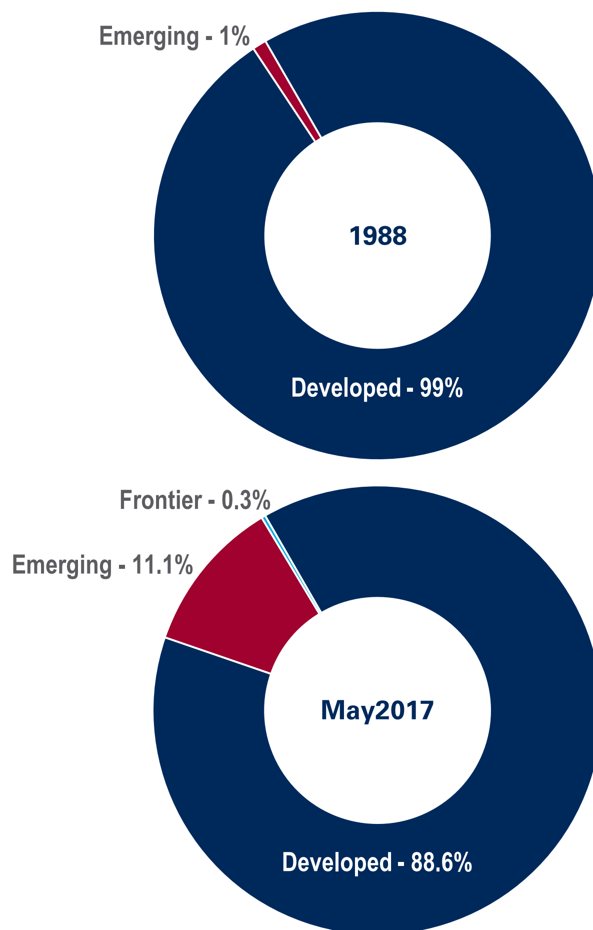
All around the Frontier Markets, high quality management teams are investing in their businesses and growing along with their countries, allowing economic and institutional development to drive higher returns and, eventually, higher multiples. If this investment approach sounds familiar, it should. It has always been the basic philosophy underpinning Emerging Market investing. But these days many Emerging Market countries have already undergone these transformative events and it's getting much harder to find and exploit these structural issues.

A historical perspective is helpful in understanding the incredible value that can be unlocked as countries develop. In 1988, when Antoine Van Agmael first coined the moniker "Emerging Markets,"[3] Emerging Markets represented less than 1% of global market capitalisation.[4] By 2016, Emerging Markets had grown to 9.6%.[5] The true believers who stayed invested in Emerging Markets for the past 15 years period experienced returns of over 10% per annum.[6] Likewise, today the Frontier Markets countries account for only 0.3% of the word's market capitalization.[7] As I will discuss below, the higher growth rates and capital deepening in these countries promises similar upside potential. It is no wonder that many refer to the Frontier Markets as "the Emerging Markets of the Emerging Markets".

Fig 1: **Frontier Markets are still "undiscovered"**
Market Cap Analysis



Source: MSCI

Continued overleaf

The Frontier Markets Universe

Vast diversity is one of the key features of the Frontier Markets. The MSCI Frontier Markets index currently includes 22 different countries. The index does not include the smaller, oft-neglected Emerging Markets with Frontier Market characteristics even though these countries warrant attention as well. So what, then, is the common thread among these vastly different markets? In our opinion, Frontier Markets are the markets that for one reason or another are consistently under-researched or completely overlooked by traditional portfolio managers. In essence, a good Frontier Markets portfolio is comprised of the countries and the companies that you don't own in your favourite Emerging Markets fund or ETF.

Fig 2: **Examples of countries we deem Frontier Markets**

MSCI Frontier Markets Index countries
Argentina, Bahrain, Bangladesh, Croatia, Estonia, Jordan, Kazakhstan, Kenya, Kuwait, Lebanon, Lithuania, Mauritius, Morocco, Nigeria, Oman, Romania, Serbia, Slovenia, Sri Lanka, Tunisia, Vietnam, Ivory Coast
Smaller EM markets with FM characteristics
For example: Colombia, Egypt, Pakistan, Peru, Philippines, Qatar, UAE
Others
For example: Georgia, Saudi Arabia, Ukraine, Bulgaria

Of course there may be good reasons why you don't already own these names in your Emerging Market fund. Many of them are simply too small. The Morningstar Diversified Emerging Markets Category has ballooned in size over the past few decades. Many successful fund managers now oversee large cap emerging market equity portfolios with USD 50bn or more in invested capital. For these behemoths, investing in Frontier Markets is an exercise in futility. By way of comparison, the 116 constituents of the MSCI Frontier Markets index have a combined market cap of USD 314bn.[8] With that magnitude of capital, a manager could purchase every outstanding share of every company included in Argentina, Kuwait and Pakistan - three of the largest markets we deem to be Frontier Markets.[9] Even for managers of smaller and more nimble Emerging Market funds, Frontier Market stocks represent a substantial commitment of research capital given the spotty or non-existent sell-side coverage. Finally, managing Frontier Markets effectively also requires a specialised and dedicated team. Very few managers are willing to make that investment given the smaller size of these markets. Whatever the reasons, the lack of competition from big emerging market equity fund managers leaves better opportunities for those managers who are willing to roll up their sleeves and do the research and for those investors who are looking for opportunities beyond the large, traditional emerging market equity funds.

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What common features do Frontier Market companies share?

Frontier market companies generally grapple with a number of issues that understandably affect their valuations.

Transparency. Frontier Market companies are often less transparent than their peers in the Emerging Markets. That means financial data may be less complete and/or compiled using less rigorous accounting methods. Management may not be as effective in formulating clear corporate messages or as timely in communicating to investors. The business terms of corporate transactions might not be shared with investors to the extent public disclosure rules would mandate in the Developed or even most Emerging Markets. Of course, fundamental research, including frequent time spent in-country, can mitigate this lack of transparency and in some situations, turn it into an informational advantage for diligent asset managers.

Sparse analyst coverage. The lower potential trading revenues to be earned making markets in Frontier companies means that it is difficult for global and even local sell-side firms to profitably cover most Frontier Market companies. This compounds the transparency problem discussed above and further enhances the potential advantage of fundamental research.

Liquidity. Lack of liquidity is a perennial issue for Frontier Market investors – it can be limited. Liquidity can also be pro-cyclical, meaning that it increases when foreign investors are sanguine on the asset classes, but flows tend to fall when this enthusiasm fades. This is yet another reason why index investing in Frontier Markets can lead to unfortunate results. As companies and countries become popular among foreign investors, index weightings increase proportionately, attracting even more investment from index-followers. At some point this cycle inevitably breaks down and index investors wake up to find themselves with suddenly illiquid securities. Active, disciplined portfolio management is the only way to identify these liquidity traps, when prices diverge from reasonable valuation levels in relatively shallow capital markets. Portfolio-level diversification as well as self-imposed limits on country and/or security concentration can also help to ensure that these risks are carefully monitored and controlled.

Common Frontier Country Issues

The structural issues mentioned above are many and varied, but some common issues are as follows:

- An imperfect political and/or judicial framework.
- Poor monetary or fiscal policy.

- Lack of adequate capital market regulation.
- Insufficient physical infrastructure.

The combination of these structural issues is another reason why even most global Emerging Market investors lack the knowledge and the confidence to make significant investments in the Frontier Markets. These are all issues that today's Emerging Markets faced 30 years ago.

Where does the Beta (and the Alpha) come from?

The path for a Frontier Market to transform itself into an Emerging or a Developed Market is precisely through the gradual improvement in these structural issues. When addressed, these improvements give added confidence to both domestic and foreign investors, allowing them to increase allocations. This is the basic story of the Frontier Markets that gives rise to the "beta" of Frontier Markets returns. In addition, through careful top-down analysis, investors can identify those Frontier Markets that are making steps forward (or steps back!) in addressing these structural issues.

As favourable demographics take hold and Frontier economies grow and develop, penetration of Frontier Market companies into their domestic markets can deepen. This provides another built-in growth driver for the value of Frontier companies. Further, the Frontier companies that are able to attract foreign investment are generally dominant or emerging leaders in their respective industries. Lack of domestic competition and obstacles for foreign firms translates into better growth prospects and multiples.

By allocating capital accordingly, asset managers are also able to achieve sustained "alpha" in actively managed Frontier Market portfolios.

Why then Frontier Markets?

Despite their well-documented issues, there is a lot to like about Frontier Markets: deepening financial markets, high growth potential, lower debt, inefficient pricing, compelling valuations and strong cash flow to name a handful. In addition, Frontier Markets offer the best diversification opportunity that Investors will find among the world's liquid equity markets.

Deepening financial markets

Frontier Markets lack the financial maturity and sophistication of developed markets. On many fronts, Frontier Markets are still implementing reforms that give investors a higher level of comfort. Political stability, a proven framework of commercial law, fair bankruptcy procedures, clear property ownership and rules around property transfer are just a few of the key areas where many Frontier Market countries still require fundamental reform. But in the Frontier Markets, these flaws and the risks they pose for investors are widely known and already priced-in by the political risk premium demanded by investors. When domestic reform occurs along any of these fronts, these "levers of change" can translate into enhanced returns for those investors who are positioned to benefit. This was always the essence of the argument for Emerging Markets and the key to unlocking their potential, but the argument is even more pronounced in Frontier Markets.

Notwithstanding their less developed status, it's important to note that Frontier Markets are not, on a whole, more corrupt than Emerging Markets. For example, Transparency International has, year after year, found less corruption in some Frontier Markets than in the BRICs – Brazil, Russia, India and China.[10] Corruption aside, most Frontier Markets are clearly less transparent than Emerging Markets. This is one of the main reasons why active managers – ones who do their own fundamental research – have enjoyed a significant performance edge versus passive strategies.

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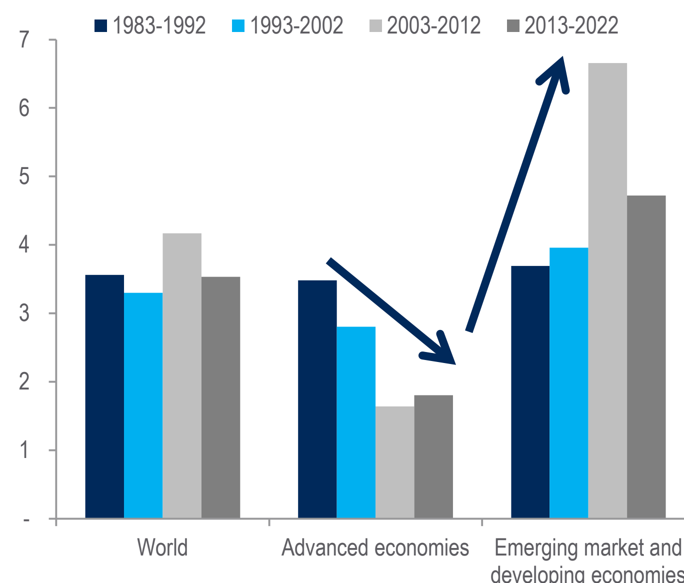
High growth potential

Frontier markets are among the fastest growing economies in the world today. They start from a lower base – the market cap of all public companies in the Frontier Markets is generally less than 20% of GDP vs.100%+ in Developed Markets and about 50% in Emerging Markets. At the same time, GDP is growing faster in the Frontier Markets, providing additional room for financial deepening. While developed markets slowed to 1-2% growth in the last few years, the World Bank and the IMF expect growth in emerging economies to settle into annual growth around 4%.[11]

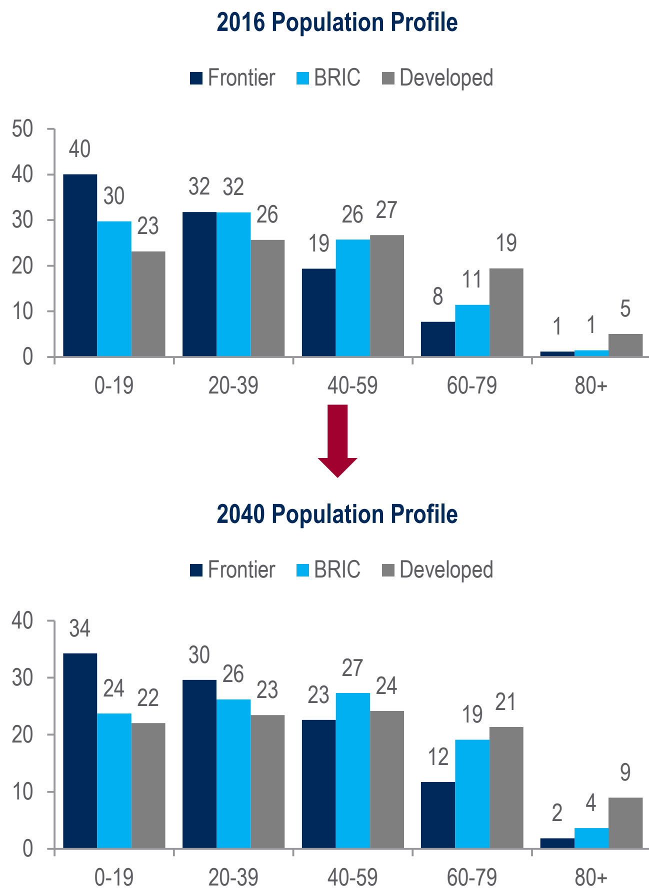
Fig 3: **Average GDP Growth (%)**



Source: World Bank as at June 2017; IMF as at April 2017

So why is this "growth premium" between developed and emerging economies so critical? Growth will continue to create an ever larger local consumer market, and with it, countless opportunities for local businesses. Governments across Frontier Markets are also seeking to multiply the benefits of growth through large-scale infrastructure projects and reforms targeting the consumer and financial sectors.

Fig 4: **Changing Population Profile**



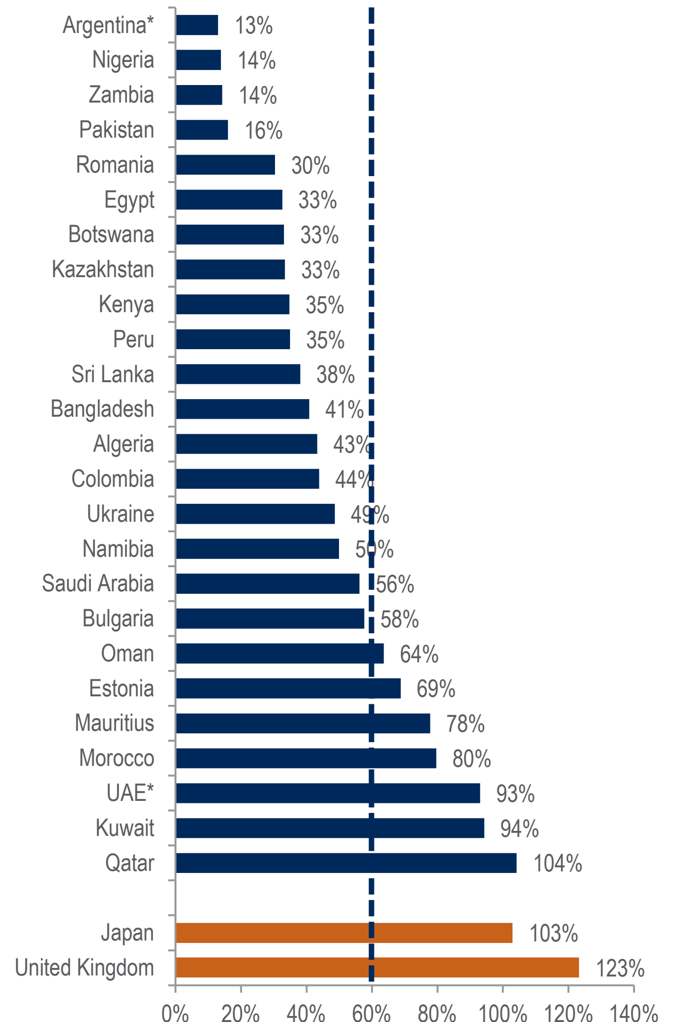
Source: World Bank as at June 2017; IMF as at April 2017

The population profile of Frontier Markets is also more attractive than either the Emerging or Developed Markets, meaning that Frontier Markets should be able to maintain favourable growth rates for decades to come.

Low debt

Debt, especially excessive debt, can compound volatility and increase risk for shareholders. On both a country and a corporate level, Frontier Markets exhibit far lower levels of leverage than either Emerging or Developed Markets. One measure of the overall indebtedness of an economy is a government's gross debt as a percentage of GDP. While the governments of advanced economies have racked up an average debt of 108% of GDP, Frontier market countries haven't been afforded this luxury.

Fig 5: **Outstanding Loans from Commercial Banks (% of GDP)**



Source: IMF (Financial Access Survey, Oct 2016)
*Estimates from Financial Access Survey, Dec 2015

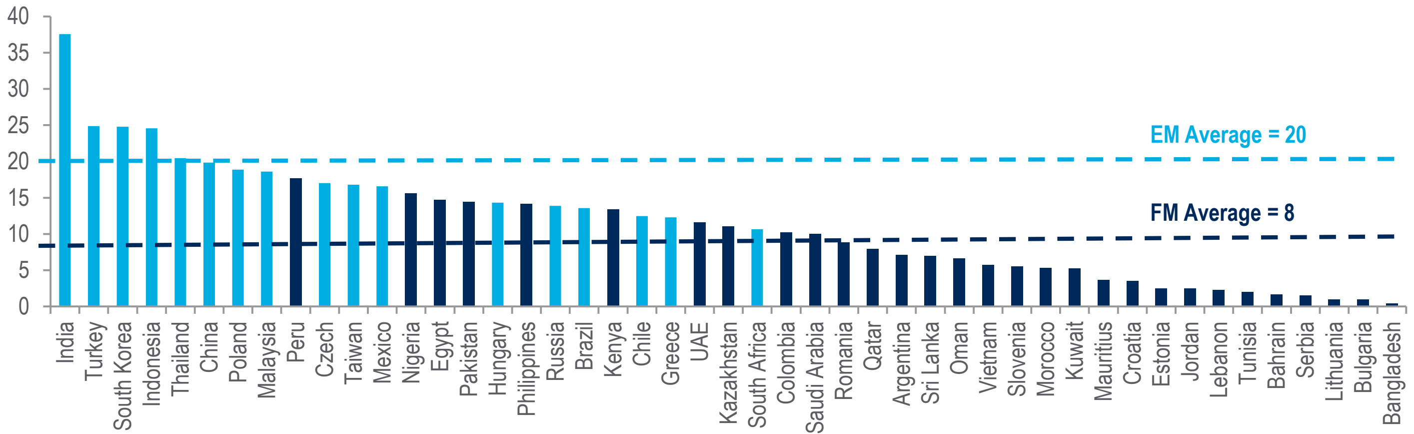
Indebtedness of Frontier Market companies are much lower -- at 60% on average – compared to 123% in the UK and 103% in Japan, for example.

Given the lower debt on their balance sheets, Frontier Market companies can add leverage to increase returns to shareholders. As bond markets of these countries grow and mature, companies have access to cheaper and more abundant financing. This is an important lever to unlock the potential value of Frontier Market issuers.

Inefficient pricing

At Ashmore, we often define Emerging Markets as those markets where Ashmore's skills work best. We say that because Ashmore relies on research to uncover value. The fewer sell-side firms or competitors spend time in a given country, or with a specific company, the higher the payoff can be for careful research. In fact, all active managers should prefer inefficient markets because

Fig 6: **Number of analyst forecasts per stock**



Source: Renaissance Capital, Bloomberg, World Federation of Exchanges (UAE = Abu Dhabi and Dubai exchanges)

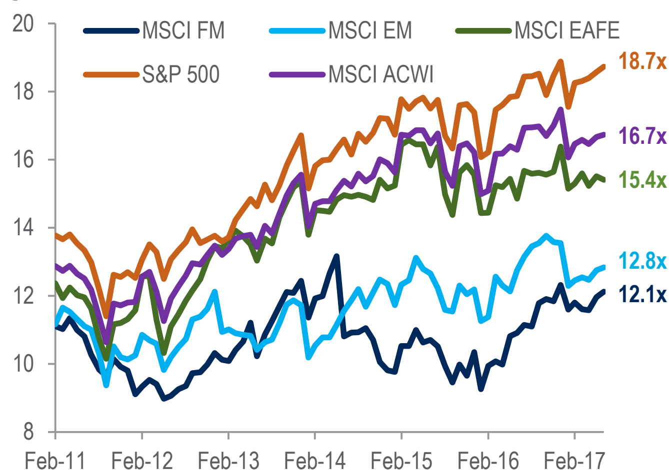
they afford more opportunities to add value. Frontier Market companies are often covered by only local sell-side analysts, if any. That's an attractive opportunity.

The Frontier Markets investor base also contributes to mispricing. The trading of Frontier Market companies is performed mostly by local retail investors – individuals, not institutions. Local retail investors are less likely to fully research their stock purchases and more likely to buy and sell for idiosyncratic or personal reasons. They are more likely to react or overreact to local news stories. Also they aren't able to compare opportunities across different markets. Global investors are well-positioned to detect such mispricing and to take advantage.

Compelling valuations

The difference between Frontier and Emerging Markets is quite stark when it comes to valuation. The cost of a dollar of earnings is much higher in the Emerging Markets, where average ROE is around 9.7%.[12] In contrast, the ROE of Frontier Market companies is a much-more attractive 15.6%.[13] While the S&P exhibits similar levels of ROE, Price/Book levels are considerably higher, at around 2.97 vs. 1.65 for the Frontier Market Index. Moreover, active managers can find even better value through careful research.

Fig 7: **Estimated Forward PERs* – Frontier Markets vs. EM and DM**

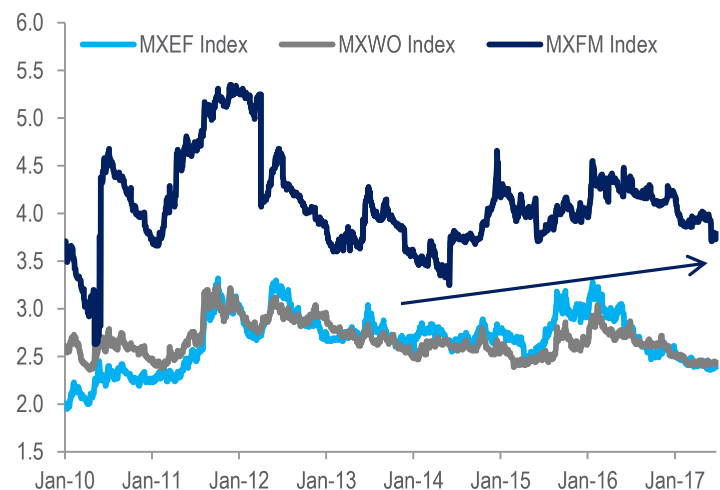


Source: Bloomberg BEst PERs as at 22 June 2017
*PERs reflect year end (calendar) estimates

Strong cash flow and dividends

A nice bonus of investing in Frontier Market equities is a consistently high dividend yield. In fact, Frontier Market companies routinely pay dividends that are higher than the coupons of developed market bonds! There are good reasons for this. Frontier Markets' lower levels of leverage mean that the holders of equity securities don't stand behind nearly as much debt. Further, a large part of the investor base of many Frontier Market companies are local investors. In many cases, among these investors are the same entrepreneurs and families that were responsible for companies' early growth and development. These investors often rely on their securities portfolios for income, so companies are rewarded for providing a stable, consistent stream of dividends.

Fig 8: **12-month trailing Dividend Yield**

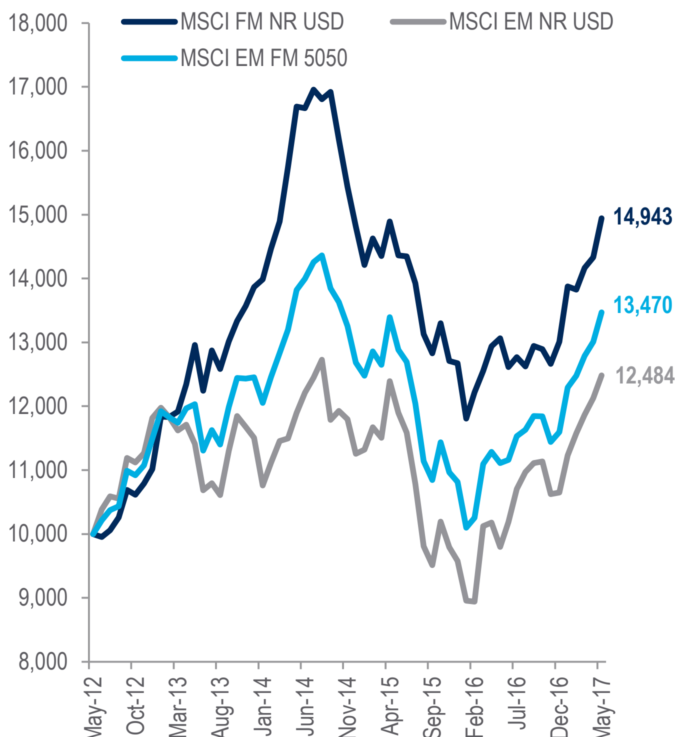


Sources: MSCI, Bloomberg as of 22 June 2017, Citi Research

A Blended Approach Works Best

Splitting an EM allocation between Emerging and Frontier Markets can enhance the risk/return profile of an allocation. Over the past five years (ending May 31, 2017), using the relevant MSCI indices, a split EM/FM portfolio handily outperformed a simple EM allocation. It achieved this outperformance with substantially lower overall volatility.

Fig 9: **Growth of USD 10,000**

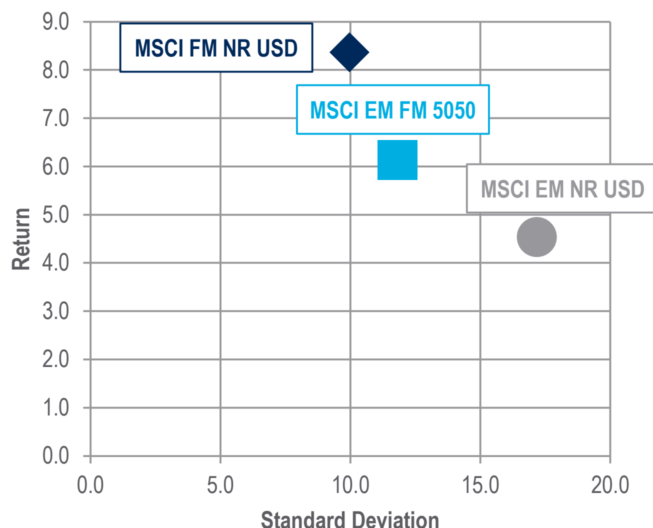


Source: Morningstar

As the chart above indicates, the MSCI Frontier Markets index has outperformed the MSCI Emerging Markets index over the past five+ years. Over that time period, an initial investment of USD 10,000 in the MSCI Frontier Markets index would have turned into USD 14,669. Great news! But there were significant lows and highs along the way. For example, the chart above reveals that in mid-2012, the Frontier Markets index was under water for the period and trailed the MSCI Emerging Markets index by a substantial margin. Two short years later, Frontier market valuations surged and the MSCI Frontier Markets index pulled ahead in this two-horse race. Finally, 2016 saw both indices lose substantial value. In fact, the MSCI Emerging Markets index erased all gains from the previous four years. Welcome to emerging markets investing!

But the chart also offers investors another option, which may for many investors be a better alternative than either Emerging Markets or Frontier Markets. A 50/50 blend of these two indices performed almost as well as the MSCI Frontier Markets index over the period, but didn't experience a draw-down of the original investment in either 2012 or 2016. That's important because many investors make the mistake of getting into and out of their Emerging Markets allocations at the wrong time. With the more stable return pattern offered by this blended approach, investors may be more likely to refrain from the bad timing decisions that can cost so dearly.

Fig 10: **Risk-Reward**



Source: Morningstar

Another way to illustrate the trade-offs involved in Emerging/Frontier portfolio construction is with a risk-return scatter-chart like the one above. Over the past 5+ years, a 50/50 blend of the MSCI Emerging and Frontier Markets indices would have reduced volatility by over 3% per annum while delivering almost 2% greater returns over the same period versus the MSCI Emerging Markets index. Clearly, Frontier Markets were the more attractive investments over this period, delivering better returns with less volatility – putting the MSCI Frontier Markets index in the coveted "Northwest Quadrant" of the chart. So why not just skip Emerging Markets altogether and invest one's entire Emerging Markets allocation to Frontier? A "naked" Frontier Markets allocation might not be a realistic approach for all investors. First, liquidity could be a major impediment for many investors. Many intermediary and institutional clients are simply too large to make such a decision without in the process swamping the available capacity of all the funds offered! Further, it's not difficult to imagine scenarios where Emerging Markets reverse this trend and perform better for sustained periods, creating a different short-term pattern of risk and return. Guessing the timing of these inevitable cycles correctly might take more resources and effort than most investors are willing to devote to this decision and there's no guarantee of success. So in summary, the most attractive approach for most investors might be the simplest one – find an excellent Frontier manager and maintain a permanent strategic allocation to the asset class.

1. International Monetary Fund (IMF), 2017.
2. IMF, 2017.
3. The Economist, Schumpeter; An Emerging Challenge, April 15, 2010.
4. Morgan Stanley Capital International (MSCI).
5. MSCI.
6. Gross annualised returns of MSCI EM Index for the 15-year period, ending June 16, 2017, MSCI and Morngingstar..
7. MSCI.
8. MSCI. Note that this figure represents only the free float-adjusted market capitalization in each country. The total capitalization of index companies is higher.
9. Bloomberg.
10. Transparency International,2015.
11. World Bank as at October 2016; IMF as at October 2016.
12. Bloomberg as of June 16, 2017.
13. Bloomberg as ofJune 16, 2017.

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