



BOLDLY GO TO A NEW FRONTIER

In a bid to enhance returns, investors are allocating assets to growth markets, such as global small cap and mainstream emerging market equities. Frontier equities, which have generally been absent from portfolios, constitute another growth market that can benefit investors. This article discusses frontier markets and what makes them an attractive option for investors.

Frontier Market Overview

Frontier markets represent an asset class with a diverse set of countries at different stages of their economic and reform cycles and home to relatively large pools of population. They are not classified as mainstream emerging markets due primarily to the early development state of their capital markets.

Frontier markets constitute countries with high rates of economic growth, but small and less liquid stock markets. Active managers commonly have a broader investable universe than the members of the MSCI EM Frontier Market Index and may include countries with capital markets that are unclassified by index providers, as well as countries in the MSCI EM index that exhibit frontier market characteristics (Figure 1).

Investors can benefit from the strong growth prospects offered by frontier equity markets, as well as their low correlation to broad equity markets.

Figure 1: Frontier Markets Investable Universe

MSCI Frontier Market Index Members			
Argentina	Jordan	Nigeria	Togo
Bahrain	Kazakhstan	Oman	Tunisia
Bangladesh	Kenya	Peru	Vietnam
Colombia	Kuwait	Romania	
Croatia	Lebanon	Senegal	
Egypt	Lithuania	Serbia	
Estonia	Mauritius	Slovenia	
Ivory Coast	Morocco	Sri Lanka	
Unclassified Markets			
Armenia	Fiji	Malawi	Saudi Arabia
Barbados	FYR Macedonia	Mongolia	Uruguay
Bolivia	Georgia	Montenegro	Venezuela
Costa Rica	Guyana	Nepal	Zimbabwe
El Salvador	Iran	Paraguay	
MSCI EM Members			
Pakistan	Philippines	Qatar	UAE

Source: Bloomberg, World Bank, MSCI

Stocks listed on the frontier market exchanges are growing in size but are a long way from the market capitalization of emerging markets.

At the end of 2018, there were 153 stocks in the MSCI Frontier EM Index, of which 122 had a market capitalization greater than US\$1 billion, which compares to 217 such stocks in the Canadian equity index (S&P/TSX Composite). The median capitalization of the stocks in the frontier index is slightly higher than that in the Canadian equity index.

This is one asset class where the investment opportunity should not be based solely on how the market index is comprised. That is because it exhibits significant country and sector biases, with the largest 10 stocks and largest three countries each representing over 40% of the frontier index, while the financial sector comprises 45% of the index. The high financial sector exposure reflects that those companies tend to be the earliest to list on developing stock exchanges.

With the index so highly concentrated, passive investing has been considered high risk. In contrast, the shortcomings of the index create attractive opportunities for active investors willing to look beyond the standard index names.

Challenges

While full of opportunities, frontier markets are associated with a number of risks due to political, currency, illiquidity, and market access challenges. Before discussing the upside potential of frontier markets, consideration of these challenges provides a useful backdrop.

Political Risk

Many frontier countries have a non-democratic form of government that typically results in power concentration and wealth accumulation among the political elite. As governments are not necessarily elected, or can be elected along tribal or religious or sectarian lines, social unrest is not uncommon. The Arab Spring in 2011 and the post-election violence in Kenya in 2013 are stark reminders.

Currency Risk

Frontier countries exhibit higher levels of currency risk due to a thin export base, a reliance on internationally priced cyclical commodities (Nigeria), a lack of an independent and properly functioning monetary policy (Middle East & North Africa), and low direct foreign investment.

Some markets have imposed capital controls in periods of foreign currency scarcity or created multiple exchange rates in the market (Argentina and Egypt).

Foreign Ownership Limits

While accessibility to frontier markets has improved dramatically over the last decade, foreign investors still face difficulty accessing stocks due to foreign ownership limits on certain companies and sectors. The issue is perhaps most pronounced today in Vietnam, where many securities are now “full” in terms of foreign ownership. In these cases, a foreign buyer must find a foreign seller to transact, often in off-market blocks and with costly broker mediation.

Liquidity Risk

Frontier markets are thinly traded when compared to developed and mainstream emerging markets. Frontier markets trade on aggregate just under US\$2 billion a day. While liquidity is improving, levels continue to be unaccommodating for large global funds. Therefore, frontier markets are often considered a less liquid component of long-term portfolios.

Key Attractions Of Frontier Markets

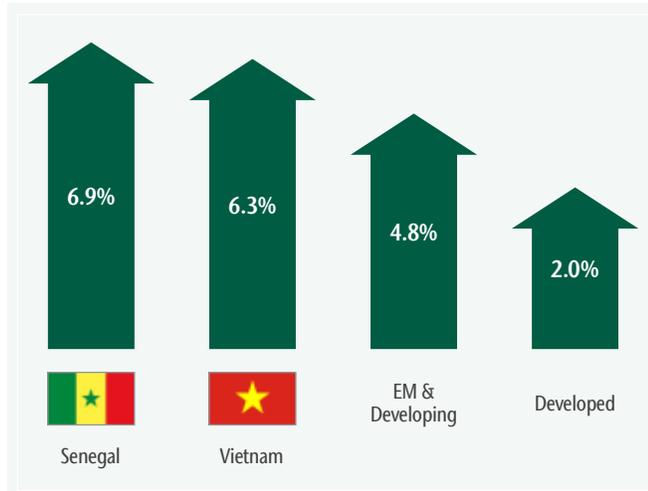
The diverse opportunity of frontier markets has some common attractions:

Robust growth	Frontier markets are among the highest contributors to global growth, despite being a relatively small portion of world market capitalization.
Reforms	Reforms aimed at increasing private sector participation in a broad range of industries are ongoing and recognized as being essential for sustained economic growth.
Demographics	Large, relatively young and growing populations underpin growth potential.
Diversification	As these countries are exposed to different macro factors and domestic investor base, they provide low correlation to broad equity markets, as well as between countries within the frontier market.
Active Opportunities	Limited sell-side research with banks still at an early stage of coverage contributes to information inefficiencies, which provides opportunities for active investment managers.

Robust Growth

Frontier markets are among the highest contributors to global growth, despite being a relatively small portion of world market capitalization. Data from the International Monetary Fund (IMF) suggests that 71 of the 75 fastest growing countries from 2012 to 2016 were frontier market economies and many of the countries are forecast to represent the fastest growing economies (Figure 2)

Figure 2: GDP Growth Projections



Source: IMP, 2018E

The IMF expects frontier market economies to grow at a pace that is 50% greater than that of developed markets from 2016 to 2021. This growth differential is similar to that of the 1990's when emerging markets grew 65% faster than developed markets, leading to the rise of countries like China and India (Dimitrijevic, 2017).

One aspect fueling growth is the ability of frontier markets to adopt technology that exists in more advanced developed economies. For example, frontier markets have been able to go straight to more efficient infrastructure, such as wireless and fiber-optic cables.

Reforms

Reforms aimed at increasing private sector participation in frontier markets have begun to take hold. Governments are de-regulating industries and opening up their economies and markets to the rest of the world. Reforms are an essential component for sustainable economic growth. Many countries have learned from their emerging market peers and are undergoing similar structural reform programs.

Political and market-oriented reforms are paving the way for many countries to transform their weak struggling economies into environments of strong economic growth. Many of the reforms that were implemented in countries such as Pakistan were followed by strong economic growth and positive market performance.

The most successful reform programs have usually included liberalization of the exchange rate, removal of energy subsidies, taxation reform, privatization programs, relaxation of direct foreign investment restrictions among other measures. These reforms should help frontier markets grow their share of global market capitalization in a way that better reflects global GDP share in the medium to long term.

Demographics

The frontier markets are home to 3 billion people, representing over 40% of the global population. It's a young population with a median age of 24 years compared to 40 years for the developed markets. Demographics play a major role in defining the future success of an economy. Population size, growth and age are key factors that determine economic growth and prosperity of a nation. A fast growing population should result in a growing labour force and strong growth in the demand for basic goods and services.

These large and relatively young populations in frontier markets underpin the strong growth expectations.

Diversification

Frontier markets can add diversification to a portfolio with low correlation to broad equity markets. However, a unique feature of these markets is each economy within the market exhibits low correlation to the others, since each country is dominated by local investors who are generally swayed by factors unique to their domestic market. (Figure 3).

With a large domestic investor base, and a small number of dedicated frontier funds, frontier countries are way less impacted by global market events that is felt by global developed and mainstream emerging market equities.

Figure 3: Low Inter-Country Correlation



	Vietnam	Pakistan	Kenya	Argentina
Vietnam	–	0.28	0.18	0.10
Pakistan	0.28	–	0.12	0.04
Kenya	0.18	0.12	–	0.12
Argentina	0.10	0.04	0.12	–

Source: MSCI, Bloomberg, as at end of December 2017. Correlations over 5 years.

Active Opportunities

Limited sell-side research of frontier market companies, with banks still at an early stage of coverage, contributes to information inefficiencies. The consensus estimates are generally an unreliable guide due to thin coverage and staleness of data, which provides opportunities for independent research by active investment managers.

The Case For Frontier Markets

Investors can benefit from the strong growth prospects offered by frontier equity markets, as well as their low correlation to broad equity markets. These countries represent a diverse opportunity set with markets that are at different stages of their economic and reform cycles and home to relatively large pools of population, which underpins strong economic growth.

Frontier markets are not without risks, such as political, currency, illiquidity, and market access challenges, which contribute to shortcomings of a passive investment approach. In contrast, these create attractive opportunities for active investment managers who are able to look beyond the standard index names and mitigate some of the risk by constructing a more diversified portfolio.

As investors seek stronger return opportunities, there is a case to be made for the inclusion of frontier markets in the growth component of portfolios.

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