Time to Invest in Frontier Market Stocks?

By Susan Weiner
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“If you remember China 20 years ago, you get a sense of the potential for frontier markets today.”

These were the words of Larry Speidell, reflecting on his first investment research trip to China back in 1987. Twenty years later, investors vie to leverage the strength of the Chinese economy. Speidell, chief investment officer of Frontier Market Asset Management, isn’t fazed when colleagues question why he is investing in frontier market stocks.

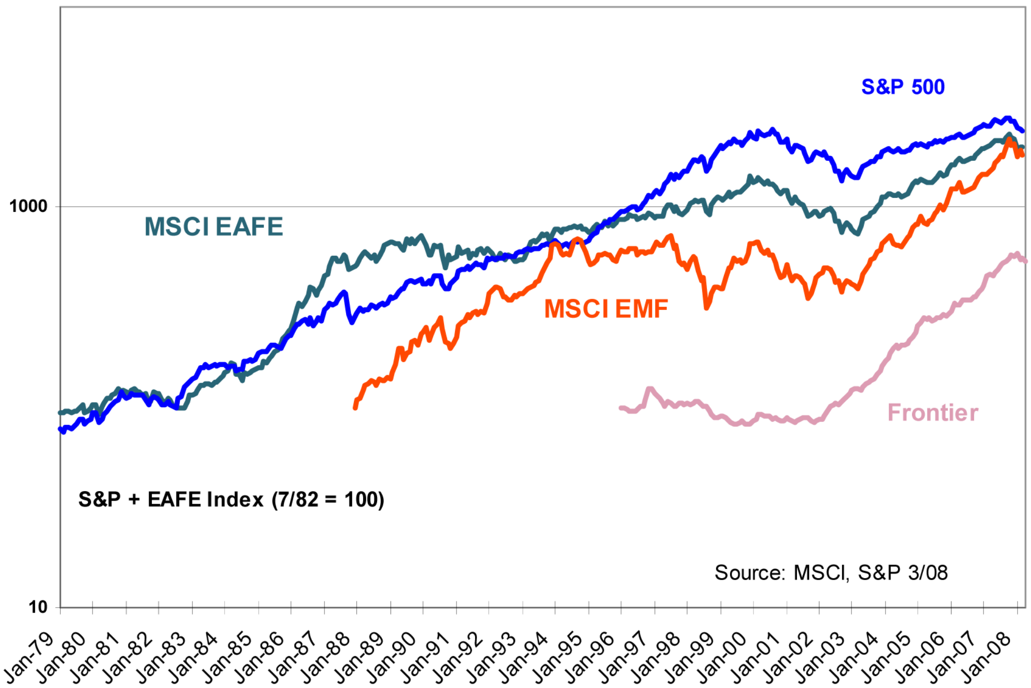
Frontier markets are any markets not included in the MSCI Emerging Markets Index, said Speidell. MSCI has its own Frontier Markets Index which includes seven countries in Europe (Bulgaria, Croatia, Estonia, Kazakhstan, Romania, Slovenia, Ukraine), four in Africa (Kenya, Mauritius, Nigeria, Tunisia), six in the Middle East (Bahrain, Kuwait, Lebanon, Oman, Qatar, United Arab Emirates) and two in Asia (Sri Lanka, Vietnam). Speidell uses a broader frontier market universe for the long-only limited partnership he manages, which also includes constituents from the S&P/IFC Frontier Composite, adding countries that MSCI has excluded in Latin America (Ecuador, Jamaica, Panama, Trinidad & Tobago), Africa (Botswana, Cote d’Ivoire, Ghana, Namibia), Asia (Bangladesh, Cambodia), and Europe (Georgia, Latvia, Lithuania, Slovak Republic).

It’s one thing for adventurous institutions to take the plunge. But it’s quite another for high net worth investors to jump into one of the few mutual fund or ETF products that incorporate frontier markets.

Frontier markets: economic growth and—believe it or not—less risk

History. Globalization. Risk. Optimism. These are the reasons Speidell invests in frontier markets. Financial advisors will be compelled by the prospects for strong returns and reduced portfolio risk that comes from understanding these four factors.

History matters, according to Speidell, because the history of traditional emerging market countries has laid a path for the frontier markets to follow, toward freer economies, greater wealth, and strong stock market performance. Returns for frontier markets have been respectable (see the graph below), but they could really take off if they follow the pattern set by emerging markets in the 21st century.

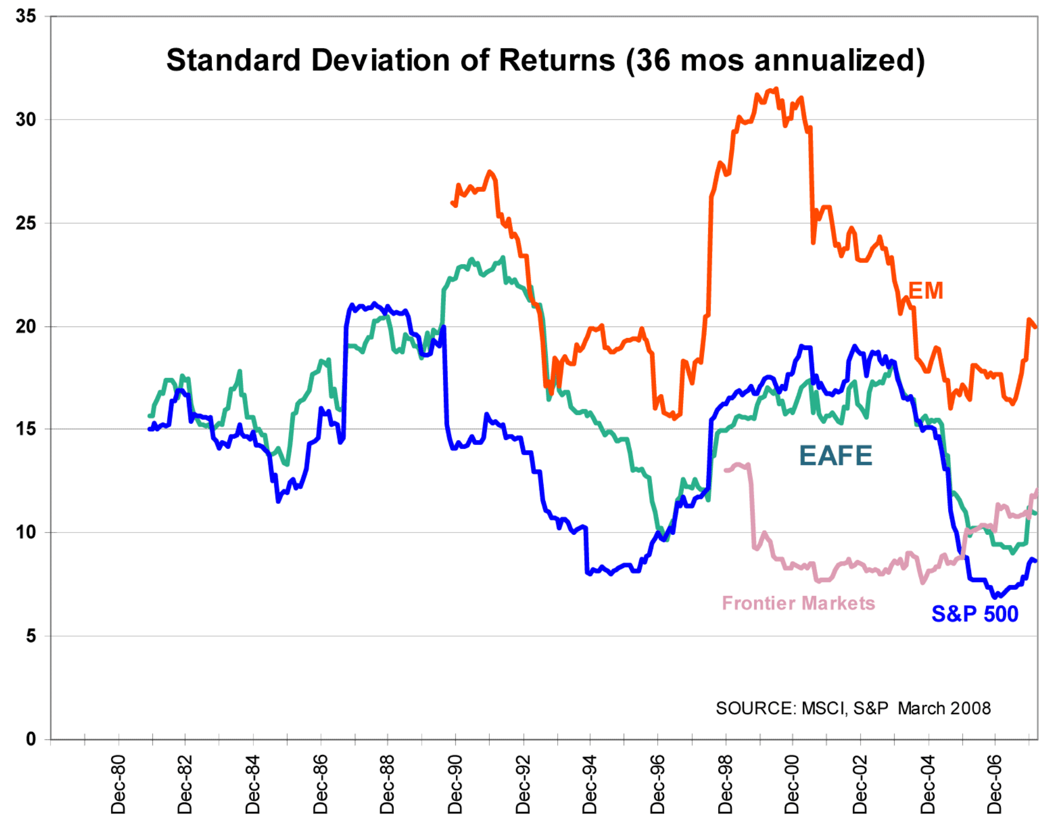


Source: Frontier Market Asset Management

Globalization is shrinking the world, noted Speidell. Today it is easier for knowledge, outsourcing, and other opportunities to reach the frontier markets. Young, rapidly growing populations are another plus. All of these make it more likely that frontier markets will follow the successful paths of their emerging market brethren.

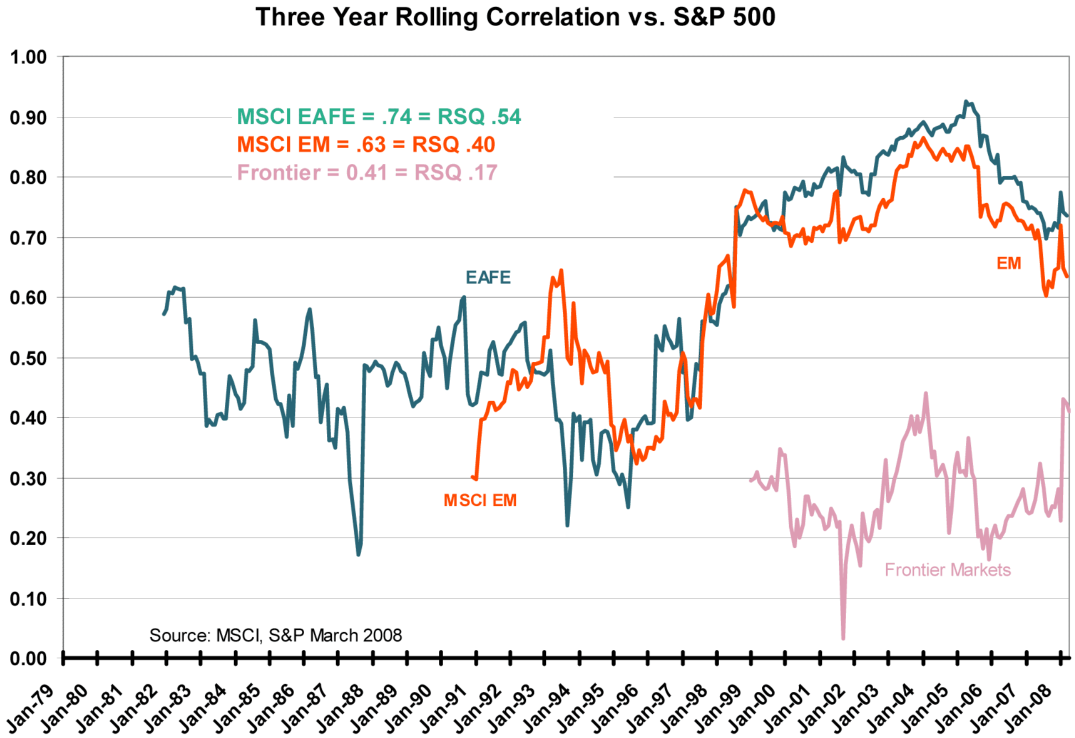
Frontier markets have two important risk characteristics for the overall portfolio:

1. As a group, frontier markets' overall volatility is low—much lower than that of the traditional emerging markets and sometimes lower than the S&P 500 and EAFE (see graph below) because individual frontier markets are loosely correlated with one another.



Source: Frontier Market Asset Management

2. Frontier markets have low correlations with developed markets—and their correlations are much lower than emerging markets' correlation with developed markets (see graph below).



Source: Frontier Market Asset Management

Incorporating a diversified group of frontier market stocks into a broader portfolio can potentially reduce portfolio volatility.

Frontier markets can be risky on a country-by-country basis because these countries tend toward volatile political and economic environments. Also, access to their stock markets can be cumbersome, liquidity can vary, custody can be a challenge, and IPO allocations can be discriminatory.

But this is where Speidell's optimism comes in. He sees improvements in the ways frontier market governments and economies function. Also, access to stock markets and to company information is improving. In the meantime, Speidell said, "There's a big payoff for those practicing good financial analysis."

How much to invest?

“If you are an optimist, you can put 25% of the equity portion of your portfolio into frontier market stocks,” said Speidell. That’s how he has invested personally, with his frontier investments complemented by 25% in traditional emerging markets, 30% in the U.S., and 20% in non-U.S. developed markets.

“High net worth investors will tone down that allocation,” acknowledged Speidell. He suggested they put one-third of their emerging market allocation into frontier markets. They should be long-term investors in these markets, he said, because trading costs are high and these markets will mature over long time horizons.

At State Street Global Advisors, Managing Director George Hoguet suggested that individual investors put no more than 1% of their equity investments into frontier markets. “Frontier markets will be volatile,” he said. They’re also illiquid, with big political risks, and they could suffer significant periods of underperformance.

Still, Hoguet likes frontier markets because some of them, like the Middle Eastern countries and other oil producers, are benefiting from an economic boom. Frontier markets also offer the possibility of return enhancement, diversification, and a broader opportunity set. In addition, “They may follow the evolution of emerging markets,” he said. If that happens, there could be an advantage for those who invest early.

Vehicles for investing in frontier markets

There aren’t a lot of mutual fund or ETF options available to wannabe frontier investors. The actively managed T. Rowe Price Emerging Middle East and Africa fund is currently the fund offering that’s the most focused on frontier markets, said Gregg Wolper, senior fund analyst, Morningstar, Inc. Currently, there are no ETFs or index funds tied to the MSCI Frontier Markets Index or S&P IFCG Global Frontier Markets indexes.

However, the Claymore/BNY Mellon Frontier Markets ETF launched in June, using The Bank of New York Mellon New Frontier DR Index. Morningstar has identified more frontier ETFs in registration, including, Market Vectors Africa, Market Vectors Global Frontier, Market Vectors Gulf States, PowerShares Middle East and North Africa, and WisdomTree Middle East Dividend. Speidell said he is considering an actively managed frontier mutual fund offering in conjunction with Nicholas Applegate Capital Management. Morningstar maintains a page on its site with information about frontier market funds in registration.

Implications for advisors

Tread carefully. The volatility of individual countries may stress you and your clients, even if it doesn't do damage to your overall portfolio. For example, if you invest in Lebanon and a civil war breaks out, you will be dealing with some angry clients, said Hoguet.

Don't bypass traditional emerging markets for frontier markets. Emerging markets still have plenty of potential, said Todd Henry, emerging markets portfolio specialist, T. Rowe Price. Moreover, he suggested, frontier markets' relatively low volatility may not continue.

Examine what's in your traditional emerging markets funds. For example, T. Rowe Price's Emerging Market Stock Fund has about 10% in frontier stocks and that may be enough for some clients, said Henry.

Consider the universe in which the fund or ETF invests. Frontier indexes' characteristics vary significantly. For example, the MSCI index is about 70% in the Middle East, while its S&P peer emphasizes Africa (34%) and Central and Eastern Europe (46%), said T. Rowe Price's Henry.

Examine your investment vehicle's diversification across companies, countries, and regions or your clients may be overexposed to unsystematic risks such as currency devaluations or political upheaval. For example, close to half of the Claymore/BNY Mellon Frontier Markets ETF is invested in Poland (24.86%) and Chile (21.01%) as of May 31. Moreover, neither of those countries are considered frontier by MSCI.

Weigh the case for active vs. passive management. Frontier markets may be less efficient, offering more opportunities to find undervalued growth companies, said Henry. Moreover, there may be a significant gap between the performance of a frontier market ETF and its index because the index can't be fully replicated. Some shares in frontier market indexes are so illiquid an ETF can't buy them.

Despite Speidell's argument for a whopping allocation to frontier stocks, consider starting small. As you learn, you may gain more confidence.

Susan Weiner, CFA, is a writer specializing in investment and wealth management.