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BIG THEME

Is it time to explore the final frontier?

Frontier markets offer the potential for high growth but come with a serious risk warning. Should private investors take the plunge?

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With growth in the developed world and emerging markets slowing down, some investors are starting to turn to frontier markets. These markets are found across eastern Europe, sub-Saharan Africa, the Middle East, Asia and South America. Less developed than emerging market economies, frontier markets have lower market capitalisations and are less liquid stock exchanges. They therefore pose much higher risks for investors. But with rich natural resources, young populations and the potential to experience strong economic growth, are these markets an area that private investors should consider?

Gavin Haynes, managing director at Whitechurch Securities, suggests investors devote a small part of their portfolio – 5 per cent or less – to the growth these countries should experience in future. "The economies that you would be investing in via a typical emerging market fund have matured quite significantly in the past decade, China being a good example," he says.

"By gaining exposure to frontier markets you're getting exposure to much earlier development of economies, where growth levels are high. That can provide some potentially exciting returns within their stock markets and hopefully replicate some of the growth that's been seen previously in some of the emerging markets as they matured."

Frontier markets can also provide useful diversification for investors because their economies tend to be less correlated with the rest of the global economy, he adds. Whereas the flow of global capital between developed markets and emerging markets means they tend to move up and down together, growth in frontier markets is driven much more by distinctive domestic factors.

This is a point that Emily Fletcher, co-manager of **BlackRock Frontiers Investment Trust (BRFI)**, concurs with. She and co-manager Sam Vecht believe that the unique factors influencing individual frontier markets make them less volatile and risky then generally thought, especially when holding a basket of frontiers.

'Vietnam has had the second highest economic growth rate in the world over the past 20 years'

As well as their usefulness in terms of diversification, Ms Fletcher says frontier markets are attractive because of their high yield and relative value compared with emerging markets. "Frontier markets have outperformed emerging markets in the past five years and a lot of that has been driven by the better earnings performance that we've seen," she explains. "[And also] because of the lower correlation with global capital flows – frontier markets are much more disconnected from those."

Both frontier markets and emerging markets are looking cheap in their own right and in relation to developed markets, she adds. With a price/earnings ratio of around 11, the MSCI Frontier Markets Index is at its lowest level in five years.

Sam Lees, head of research at FundExpert, recognises that frontier markets are especially cheap at the moment, but says investors should be cautious of trying to time underdeveloped markets.

"The opportunities for substantial growth are much better in a frontier economy just because of the base they're starting from, so your opportunities over the longer term are going to be better, compared with developed markets. But it's difficult to pick good entry points," he says.

"In terms of valuation now is certainly a time to start looking at frontier markets, but because of the risk involved it's not the case that you should just go all in."

KEY FRONTIER MARKETS

Argentina, South America

BlackRock Frontier Investment Trust's top geographic allocations include Argentina, Pakistan and Bangladesh, which account for more than a third of its portfolio. The trust's managers have been buying more in Argentina since the election of reform-focused President Mauricio Macri, who has taken several investor friendly actions, including eliminating currency controls.

"The change in governance and economic environment has been extremely fast, and the extent of change has been even more than we expected," Ms Fletcher says. "Continuing shifts towards economic orthodoxy, Argentina's return to the international capital markets and a number of other measures mean we believe that the cost of investing in Argentina can come down. And therefore there is substantial value to be had from some of the investments there."

In particular, the trust has large holdings in Argentine banks, which Ms Fletcher says could double or treble in size over the coming years. Currently, Argentina has the lowest level of banking penetration in South America, despite being a middle-income country with gross domestic product (GDP) per capita of around $10,000, but this could change if the country continues to grow, says Ms Fletcher.

Nigeria, Africa

Tim Cockerill, investment director at Rowan Dartington, believes sub-Saharan Africa offers potential opportunities for investors interested in frontier markets. He says: "We're looking – although not quite on the same scale – for the new China and Asian economies and we will find them in places like Africa."

Carlos Hardenberg, senior vice-president and fund manager at **Templeton Frontier Markets Fund (LU0768359852)**, also believes that Africa, and in particular its most populous country, Nigeria, offers exciting future potential. But he warns investors that they will need to be patient and understand some of the unique aspects of doing business there – as well as the risks.

"The fall in commodity prices in the past couple of years has been a challenge for African countries, particularly those dependent on oil revenue [like Nigeria]," he

Ways to tap into frontier markets

Even if you don't want to invest directly in frontier markets funds or stocks, there are other ways to access these markets, says Gary Potter at BMO Global Asset Management.

"I have never, ever bought a frontier markets fund. Not because they don't look interesting, but because I let my global emerging managers do that job for me," he says.

"You must remember there are plenty of very mature, high-quality, blue-chip businesses in the developed world that are themselves putting business interests into these areas, so you can also get good exposure to frontier areas by buying them."

He favours **Hermes Global Emerging Markets Fund (IE00B3DJ5K90)** as a way to get some exposure to frontier markets. This fund is not widely available to private investors, but can be found on some broker websites, such as *bestinvest.co.uk*.

For those who are fully aware of the risk but would still like to invest in frontier markets he suggests committing less than 1 per cent of your portfolio to them, and taking at least a five- to 10-year view.

Mr Lees likes **Templeton Frontier Markets Fund**, run by Mark Mobius and Carlos Hardenberg, because of its high exposure to Vietnam. "Given its position in Southeast Asia, Vietnam is quite exciting. There's a lot of potential in that country," says Mr Lees.

Both Mr Haynes and Mr Cockerill suggest **BlackRock Frontiers Investment Trust**. Mr Haynes says the investment trust structure works particularly well when investing in frontier markets, because the managers can take a long-term view and not worry about having to meet redemptions. Mr Cockerill also rates the BlackRock management team for their experience.

He says: "My broad advice would be to stick to the big managers like BlackRock because of their experience and reach, and because they're diversified. They're generalists in specialist areas. I'd suggest that, rather than going down the route of a more concentrated fund that invests in just one region, for example."

Frontier fund performance

Fund	1-year total return (%)	3-year cumulative total return (%)	5-year cumulative total return (%)	10-year cumulative total return (%)	Ongoing charge (%)
BlackRock Frontiers Ord	-2.4	16.0	34.6	na	1.6
Hermes Global Emerging Markets Z GBP Acc	-9.6	12.5	13.8	na	1.14
T Rowe Price Frontier Mkts Eq A USD	-5.2	na	na	na	1.27
VietNam Holding Ord	21.0	76.2	145.3	na	2.93
Templeton Frontier Markets A Acc EUR	-9.7	-2.8	5.0	na	1.72
AIC Country Specialists: Asia Pacific sector average	-8.5	29.1	29.9	59.0	
AIC Global Emerging Markets sector average	-10.6	-16.8	-2.4	34.5	
IA Global Emerging Markets sector average	-12.9	-10.0	-8.4	48.3	
MSCI EM NR GBP	-16.2	-10.9	-10.9	50.8	
MSCI Frontier Markets NR USD	-7.4	12.7	21.9	25.7	

Source: Morningstar as at 6 May 2016

says. "However, it could also be viewed as an opportunity for these countries to reform and diversify their economies.

"We are seeing a number of large multinational companies establish a presence in Africa for the first time – particularly in countries with improving infrastructure and ease of doing business – to access its large, vibrant and youthful populations."

Vietnam, Asia

Vietnam is another area that has been generating interest among investors for some time. Jean-Christophe Ganz, chairman of Vietnam Holding Asset Management, which runs the **VietNam Holding (VNH)** investment trust, says Vietnamese equity valuations remain cheap, particularly compared with the wider region. He believes the country offers good opportunities for active managers, with corporate earnings projected to grow by 8.8 per cent in 2016.

He says: "Vietnam is a large country. It has 95m people and a young population – the average age is 28 years. It is also a relatively well educated population. Vietnam has had the second highest economic growth rate in the world over the past 20 years, after China. India is very close – but Vietnam has outperformed it. The political system is very similar to China – it's a one-party system communist state – but they have a very strong liberal capitalist economy sector and a lot of entrepreneurial freedom."

Iran, Middle East

Iran, although not included in the MSCI Frontier Market Index, is on the radar of Oliver Bell, who runs the **T Rowe Price Middle East & Africa Fund (LU1079768849)**. Its plus points include a youthful population, and the highest literacy rate in the Middle East and North African region. He believes the recent lifting of US sanctions will also bring the country back into the wider global community.

Following a recent visit to the country, Mr Bell says: "Iran appeared more like Turkey than Saudi Arabia – Tehran being a very cosmopolitan city with a much more liberal attitude than we expected. Interest in Iran will grow going forward because of its reintegration into the global economy, its huge hydrocarbon power and its positive demographics – which will be key to future growth prospects."

Frontier market risks

Investing in underdeveloped economies with less liquid stock exchanges, different cultures and idiosyncratic political systems poses a number of risks – risks that are just too high for ordinary private investors to justify, according to Gary Potter, co-head, F&C Multi-Manager at BMO Global Asset Management: "The frontier markets are interesting, but people must be aware that they carry a disproportionate amount of risk. Like everything else it's a case of what price you pay when you go in and what you're getting. And I'm afraid people think they might be getting blue-sky stocks and opportunities, but they don't actually remember the black hole risks. So I don't think it's that suitable for the average private investor to invest there," he says.

As well as the political risks, he says investors also need to plan for more frequent recessions and currency risks.

"In some cases in frontier markets you're accessing local emerging market currencies, unless you're buying hard currency-hedged securities. You could be accessing quite volatile currency markets. Look at Brazil – that's a more mature emerging market and its currency has fallen dramatically, while its interest rates have gone up significantly," he says.

"Historically, these countries have borrowed their debt in US dollars, but they have to finance it out of local currency. If their local currency underperforms, their debt mountain goes through the roof. Hence countries such as Argentina and Venezuela were compromised over the past 25-30 years because their currencies had gone the wrong way."