INVESTMENT BRIEF

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Strategic Investment Group®

Exploring the Next Frontier

The term "frontier markets" was introduced in 1992 by the International Finance Corporation to refer to a subset of emerging markets on the frontier of the investment universe. These markets, with their inefficiencies and low level of integration with more developed world economies, are thought to offer investors increased diversification and alpha opportunities.

What are frontier markets? There is no universal definition. A number of indices have emerged over the last decade to help define the universe, which generally includes nascent markets in Asia, Africa, Europe, Latin America, and the Middle East. Collectively, these countries represent 17% of the world's population, 7% of its landmass, and 7% of its GDP, but only 1% of its market capitalization. The countries are heterogeneous in terms of population, primary economic drivers, and level of wealth. For instance, the universe includes wealthy nations like Qatar, where GDP per capita is over $100,000, and small, financially inchoate markets such as Zambia. Although frontier market countries differ in many ways, the characteristic they share is that their capital markets are underdeveloped.

Frontier markets exhibit attractive investment attributes, in particular their market inefficiency and relatively low correlation with the rest of the equity universe. They provide the opportunity to expand the investment set through the inclusion of a diverse group of countries less intertwined with global economic cycles. Moreover, the companies that make up frontier markets are much more locally driven than those in other markets.

On the return front, stock level inefficiencies are significant, arising from information asymmetries, behavioral biases, structural barriers, data deficiencies, and relatively thin sell side analyst coverage. These inefficiencies create opportunities for skilled active managers.

The risk reduction potential comes from enhanced diversification. While return correlations within public equities have been rising elsewhere, reflecting diminishing diversification opportunities, frontier markets still exhibit low correlations — less than 0.6 — with developed and mainstream emerging market stocks. In addition, as the drivers of growth differ significantly from one frontier market country to another, correlations between frontier countries are also low. On the other hand, frontier markets' 18% annualized 10-year trailing volatility (versus 24% for emerging markets) is likely understated, as it is reduced by lack of trading and low currency volatility.

It is important that one balance the potential opportunities present in the frontier markets against a host of risks and challenges endemic to these early-stage economies. Structural factors make frontier markets more vulnerable to sovereign, geopolitical, and inflation risks. In addition, corruption is widespread in some countries. Trading conditions can be challenging, as liquidity is tight, transactions costs are high, and logistical hurdles can be considerable.

The upside to challenges and barriers to information accessibility is that one should expect to be compensated for bearing these additional risks. It is also important to note that many of these countries are making good progress in developing robust regulatory and capital investment frameworks, and in enforcing global accounting standards.

The most direct way to achieve frontier market exposure is through a dedicated allocation to one or more frontier equity strategies. Manager selection is critical, given the risks and challenges described above. Key selection criteria include experience and an investment track record in the frontier markets, broad staff and infrastructure resources, trading and operations expertise, and an information/data advantage. The best strategies achieve broad exposure across a wide range of countries and companies to take full advantage of the low intra-market correlation feature of the frontier markets, while also following a benchmark-agnostic approach to limit concentration risk. An allocation should be big enough that the investment has some impact at the segment level, but not so much that the tracking error moves beyond the investor's comfort zone. Of course, the limited availability of open and suitable commingled vehicles for investing in frontier markets will constrain an investor's choices. Timing is another issue. Relative valuations are not as attractive as they were a year ago, although they still look reasonable.

In our view, frontier markets should be viewed as a special opportunity to extend and diversify the equity segment. They represent a unique equity exposure with high potential economic growth, low correlations to other asset classes, an attractive historical risk/return profile, and low overall volatility driven primarily by low intra-market correlations. They deserve to be considered for inclusion in investor portfolios, and we are actively exploring the investment opportunity and related implementation vehicles.

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