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Frontier Markets Faring Better than Emerging Markets

By David Larrabee, CFA

It may not compare with the "Great Rotation," but mutual funds that invest in emerging markets have reportedly seen more than $2 billion in outflows so far in 2013, while funds focused on frontier markets, often referred to as "pre-emerging" markets, have seen assets under management swell by more than $1.5 billion in the year to date. What explains this divergence in fortunes?

Performance-chasing investors have no doubt noticed that the MSCI Frontier Market Indices have returned 10.5% through August of this year while the MSCI Emerging Markets Indices have returned −11.9% over the same period. Look beyond the numbers, however, and the answer seems to be related to the comparative degree of integration into the global economy and the appetite for foreign capital.

The current turmoil in emerging markets can be traced back to May, when the US Federal Reserve first indicated that it would begin to “taper” its bond buying program. It was the loose monetary policies and low interest rates of the US, as well as other developed nations, including the United Kingdom and Japan, that sent yield-starved investors in search of higher returns in emerging economies. This capital, along with strong demand from China, helped to fuel economic booms in emerging market darlings like Brazil, India, Indonesia, and Turkey. For these same countries, the reversal of this capital flow has resulted in currency weakness, rising interest rates, and slower growth. More recently, concerns about further destabilization in the Middle East and rising oil prices have served to further undermine prospects for emerging market economies.

Frontier markets have managed to escape some of the problems facing emerging markets in part due to neglect; that is, they are too small to matter to most investors. Representing just 20% of the world’s population and only 10% of global GDP, frontier stocks comprise just 2% of global market capitalization. Because of their relatively small size and limited liquidity, frontier equity markets don’t attract “fast” money. Frontier market investors tend to be specialized managers who, by necessity, take a long-term view. While frontier market equities were not beneficiaries of the huge wave of liquidity that spilled into emerging market stocks, they also avoided the sell-off when this tide began to reverse course.

Despite the perception that frontier stock markets are dominated by commodity producers heavily reliant on demand from China and other fast-growing economies, financial firms make up over half of the MSCI Frontier Markets Indices. Many of the major energy and resource firms are global multinational companies or government-owned, with smaller firms often listed in London or Toronto. Whereas the stocks of emerging market firms are often leveraged to the fortunes of the developed world, frontier market equities tend to more pure plays on the growth of their home countries.

The unrest in the Middle East and the corresponding spike in oil prices have undoubtedly caught the attention of consumers and investors in those developed and emerging markets that are net importers of oil. This problem is only compounded in the case of countries with weakening currencies, most notably India. With frontier stock markets dominated by financial, telecommunications, and consumer stocks, the impact of rising energy prices is comparatively benign.

Zambian-born economist Dambisa Moyo, author of *Winner Take All: China's Race for Resources and What It Means for the World*, sees significant opportunity in frontier markets, noting the solid capital base, young labor pool, and improving productivity that is characteristic of these markets, particularly those in Africa. She also points to the lack of correlation with the economies of developed and emerging markets as another selling point for frontier stocks, though she acknowledges deepening economic ties to China make them vulnerable to a slowing Chinese economy.

Charles Robertson, global chief economist at Renaissance Capital and lead author of *The Fastest Billion: The Story Behind Africa's Economic Revolution*, is also bullish on Africa's prospects. He thinks sub-Saharan Africa will overtake China and India as the economic growth story of the future. Renaissance predicts that Africa's economy will grow from $2 trillion to $29 trillion by 2050 — greater than the current economic output of both the US and eurozone.

Of course, frontier markets are not without risks. In *Frontier Market Equity Investing: Finding the Winners of the Future*, Larry Speidell, CFA, sees opportunities in frontier markets — he's also keen on sub-Saharan Africa — but potential pitfalls as well. Local politics must be understood, and there are pockets of corruption and instability. Further, liquidity is scarce, transaction costs can be steep, and currency risk is real. As if that's not enough to worry about, there's also the risk of nationalization.

While frontier markets have delivered for equity investors so far this year, offer the allure of potential great growth, and have until now avoided many of the troubles plaguing emerging markets, they remain suitable only for investors with the expertise to navigate the many risks and the fortitude to stay for the long haul.