NYU STERN

Issue 9
December 2017

eVALUATION:

Investing Insights brought to you by the students of NYU Stern

LETTER FROM THE EDITORS

Emerging markets have had a strong year throughout 2017, which has inspired us to examine investing in these dynamic and unique markets as we seek to provide our readers a view on the outlook for emerging markets as we enter 2018. We take a thorough examination of these markets, speaking with industry professionals across both equity and fixed income. While Brazil, Russia, India and China all remain top of mind markets for investors, we also examine additional exciting growth opportunities in the Frontier markets.

While both the US and Europe have faced political challenges throughout 2017, many investors are increasingly intrigued by the high growth and long term opportunities in emerging markets. As of December 29, 2017, the MSCI Emerging Markets Index is up 34% YTD and the MSCI Frontier Markets Index is up 28%, in comparison to an 19% rise in the S&P 500 and 21% increase in the MSCI EAFE[(1)]. China, India and Russia have all contributed to the strength in 2017, while Brazil has struggled with political and corruption issues that have weighed on the market throughout the year. While valuations have moved higher in emerging markets, country and company fundamentals still appear to support continued allocations toward these markets in 2018.

The eVALUATION (eV) team is proud to present to its readers the ninth edition of the newsletter with the theme: "Investing in Emerging & Frontier Markets" – featuring interviews and opinions from leading industry professionals. In addition, the newsletter features an investment idea from the MBA student body at NYU Stern and coverage of recent events held by Stern's Investment Management and Research Society in the Fall 2017 semester. We hope that you enjoy this issue and the varied perspectives on investing in the dynamic emerging and frontier markets. Finally, we would like to thank our interviewees for their time and contributions, as this would not be possible without their valuable insights.

Happy Reading!
eV Editors

1: S&P Capital IQ

INSIDE THE ISSUE

SIMR Stern Investment Management & Research
Leonard N. Stern School of Business | New York University

Featured Interview: Alison Graham

Chief Investment Officer, Voltan Capital Management

Alison Graham is the founder and Chief Investment Officer of Voltan Capital Management. She serves as the manager of Voltan Frontier Markets Fund, Ltd., determining the fund's overall investment themes and country allocations. Ms. Graham has over twenty years' experience in emerging markets finance as a portfolio manager, equity analyst and corporate advisor.

Throughout her career, she has specialized in frontier and early-stage markets, following their development into mainstream emerging markets. In 1995, Ms. Graham joined Caspian Securities, an investment bank dedicated to emerging markets, as a senior equity analyst for Latin America. In 1998, Ms. Graham relocated to Moscow, Russia to join United Financial Group as a senior analyst focusing on Russian equities. Since 2000, she has managed assets and served as a financial advisor to a variety of firms with interests in frontier countries. She spends much of her time conducting on-site company visits in the frontiers and is skilled at trading in low-liquidity environments.

Ms. Graham holds a master's degree from the University of California at Berkeley, is a Chartered Financial Analyst and is fluent in six languages.

eVALUATION (eV): Can you tell us a bit about your background and your career thus far?

Alison Graham (AG): I've always done whatever was frontier at the time. I worked for a Latin American broker out of college. But when Latin America became well-traversed by foreign bankers, I moved to Moscow which had just launched its stock exchange. I spent several years in Moscow working in equity research and investment banking. When Russia became a similarly well-known market, I looked around for the next frontier opportunity. Rather than focusing on a specific region, there was almost no one at the time investing in frontier markets as a global strategy so I decided to launch a fund for global frontiers.

eV: What drew you to frontier markets?

AG: Frontier markets are the most dynamic and exciting part of the global economy. Companies there show great creativity in problem solving in difficult environments and governments are open to innovation. For example, several countries in Africa are experimenting with medicine delivery by drone to villages with poor road access. Small-scale solar projects are now ubiquitous. Beyond that, even though frontiers have become a popular investment strategy, not many people travel to visit the locally listed companies in their home markets. Because direct research is labor-intensive, there is a lot of inefficiency in information gathering - one can find terrific stock picks and overlooked stories by making the effort to travel.

eV: Can you provide some background on your firm, Voltan Capital? What are the core tenets of your strategy and investment process?

AG: The fund started trading in April 2009 near the bottom of the market. We look mainly for stocks that are cheap with a catalyst. Many investors in frontier markets feel most comfortable with larger cap companies or with the local subsidiaries of multinational parents such as Nestle Nigeria or Unilever Ghana, thinking they have better risk controls. Although staying with large caps for liquidity is a valid strategy, those companies tend to be fairly expensive. We look at the other end of the spectrum: companies that are overlooked or have gone through difficult times but have a clear reason to re-rate. We find that, in practice, inexpensive valuations and a local investor base give us more downside protection than companies with high foreign participation where money may exit quickly.

At the country level, we find some of the best returns in countries coming out of a crisis. For example, we visited Jamaica in December 2013. After the financial crisis, the country had gone through a series of debt restructurings and no one was looking at the equity market there. Then a new government began implementing reforms and managed to get public finances in order. The IMF certified that Jamaica was complying with the terms of the financial assistance it had received and remittances from the United States were recovering strongly. Yet stocks at the time were trading at an average P/E of 5x with 6% dividend yields.

With debt restructuring behind it and local investors moving back into equity, we saw a catalyst for people to take a new look at Jamaica. This happened over the next year: the market index was around 80,000 at the time and has gained nearly 250% since then. Not every opportunity works out that well, but those chances seem to appear more often in frontiers than in more developed markets.

eV: What inspired you to launch your own fund from a business perspective as opposed to joining an asset management firm?

AG: I think the spirit of adventure. I like the idea of creating businesses from scratch and taking advantage of opportunities before they become well known. Frontiers feel like a wide-open space where one can create something new. In countries like Iraq, which is starting to recover both from military conflict and low oil prices, or Vietnam which is modernizing at an impressive pace, there is exciting investment potential in almost every sector if one is willing to spend time in those countries and put in the hard work of identifying viable investments.

eV: There are around fifty countries that qualify as frontier. How do you cover them all and organize the portfolio?

AG: Not all countries are of equal interest all the time, so we start by grouping them into three categories: countries where we are active now like Republic of Georgia or Nigeria, countries where we may invest soon based on specific catalysts, like Saudi Arabia, and countries that are not immediate investment targets due to political conditions, such as Venezuela, or overvaluation, such as Bangladesh.

Thereafter, part of the portfolio is organized by theme. Constructing baskets of securities around a theme, such as Middle East healthcare or Asian consumer companies, minimizes individual company risk while allowing us to leverage research efforts into a given sector.

eV: How do you balance top-down country selection with bottom-up stock selection?

AG: Many of the larger funds will start with a top-down allocation and fill in stocks to meet the country quota. We tend to think more thematically – what is the overall story in the country - rather than picking countries based on GDP growth or other macro factors. For example, the Romanian economy has been doing well for the past couple years. That doesn't mean we will buy the top ten market caps in that country, but rather that we will look in a more detailed way at how political and economic changes might play out, what companies and sectors will benefit, and whether equity or fixed income is the best venue. Top down just means we will get on a plane and spend time there meeting companies in preference to other countries in our universe.

Even within a country, how do you decide where to start looking? This is where the themes come in. Medical services are a good example. As incomes rise, people consume better healthcare just like other consumer goods. So the first step is to identify the theme, next we identify all of the listed companies in that sector across countries, then we visit all of them, and finally we pick out the companies we like on an individual basis to add to the portfolio as a thematic basket. We may start looking at 20 companies and end up with four or five that go into the portfolio.

eV: What are some of the key differences between investing in frontier markets versus emerging and developed markets?

AG: Two major differences come to mind. The first is that the investor base is very different which creates a different stock market dynamic. In most frontier countries, the vast majority of capital is local, from both retail individuals and institutions such as pension funds and insurance companies. This means the capital is fairly captive and domestic investors view their own risk environment differently than foreigners do. Local capital mainly moves between the domestic equity and debt markets based on dividend versus bond yields but it doesn't flee the country entirely. Conversely, since much more capital on emerging markets exchanges comes from developed countries, stocks trade as much on global risk factors and developed market financial conditions as local ones. This means the true diversification investors can achieve is greater in frontier markets than in mainstream emerging markets.

The second difference relates to information availability. In developed markets, dissemination of corporate information is highly regulated and most public firms have sophisticated investor relations teams. Most emerging market corporates have become proactive in their outreach to investors as well. Yet in frontiers, almost the entirety of our information comes from traveling to meet local companies in person. Because our markets are less efficient in disseminating information, investors can benefit from a type of arbitrage: higher returns in exchange for the hard work and travel to obtain that information.

eV: What should investors that haven't been exposed to this asset class consider before investing in frontier markets?

AG: Be realistic about return expectations and be willing to wait out some volatility. Frontiers are a long-term story and there is a lot of white noise in stock prices so we are betting on an upward trend rather than short term moves. Be willing to consider countries that sound risky – often the darling is overvalued while countries coming out of a crisis like Ukraine, Iraq or Egypt can yield the best risk-adjusted results. Diversification really works in frontier markets so even a group of higher risk countries can produce a comparatively low volatility portfolio.

Don't get too focused on the index. It is just a list of the largest companies, good or bad, regardless of fundamentals or market timing. Frontiers are the quintessential stock pickers markets where returns are very high to country selection, stock selection and market timing. Frontier beta is not a bad investment on its own but buying an index gives up the exceptional alpha potential of these markets.

Finally, don't get too focused on the index. It is just a list of the largest companies, good or bad, regardless of fundamentals or market timing. Frontiers are the quintessential stock picker markets where returns are very high to country selection, stock selection and market timing. Frontier beta is not a bad investment on its own but buying an index gives up the exceptional alpha potential of these markets.

eV: What excites you most about this asset class?

AG: From a social perspective, one can make a large impact with little capital. We see this more explicitly in microfinance, direct lending and private equity, but liquid, well-functioning public equity markets that efficiently convey developed world capital to high growth frontier companies also play an important role. We try to do our part by focusing on companies with an underlying social benefit such as healthcare provision or job creation.

From a financial perspective, there are inefficiencies in frontier markets that one can exploit for higher returns. Many sectors still see low penetration, low competition and the ability to establish a dominant market position with new products, as Safaricom has done in Kenya with mobile money transfers. Firms that arrive first with adequate capital and strong operations can make larger returns than in more competitive emerging and developed countries. There is also significant upside potential to debottlenecking. Firms that provide off-grid electricity, transportation options, rural banking and other critical services can create significant value for themselves and for other companies in the area.

In addition, most frontier markets still are in the easy part of the growth cycle where simple reforms can have a large financial impact. Many of our best investments have been in countries that are implementing sensible monetary policy, eliminating expensive subsidies, allowing their currencies to float freely and removing restrictions on foreign investment. These types of reforms are much simpler than, for example, restructuring the Brazilian pension system or modifying China's growth model.

eV: What are some of the key risks to investing in frontier markets?

AG: The risks are often not what investors imagine. We are often asked about corruption, nationalization, civil war, coups and other big headline risks. When we lose money in the portfolio, it is almost never from that type of risk. It is usually from either completely idiosyncratic events or erratic government policy.

For example, in 2011, the Bangladeshi government decided that margin lending to local retail investors was creating a stock market bubble. It haphazardly announced an 80% reduction in the maximum margin brokers could offer, leading to a raft of margin calls. The market declined by 30% within four weeks. Saudi Arabia's decision to block transit points into Qatar is a more recent example. Disagreements between the countries had been simmering for years but the blockade, which took the Qatari market down 23% in six months, was unpredictable. The answer to this type of risk is to maintain a well-diversified portfolio. Given the minimal correlations among frontier countries, events like these usually have little or no effect on our holdings in other regions.

eV: What about the risk of currency devaluation?

AG: Devaluations are less of a problem for us than most people think. Roughly one third of frontier countries use a hard currency, like Eastern European countries inside the Eurozone, or are robustly pegged to the dollar like most of the Middle East oil producers. The other countries typically can't manipulate their currencies extensively as that requires either lots of foreign reserves which they need more crucially for imports, or capital controls which scare off foreign investment.

If a currency is trading on a free market basis, then we can estimate how it should move under various market conditions just like any other security. Most frontier currencies will depreciate by a few percent per year under normal conditions but we are looking for equity returns well in excess of that. Countries which do attempt to peg their currencies and set themselves up for a large devaluation are always quite obvious. Nigeria attempted to do this after oil prices fell in 2014-15 but gave in when dollar liquidity and foreign investment nearly vanished. There was a yawning gap with the black market rate so no one was surprised when the naira crashed. In cases like this, we simply avoid investing in the country until the devaluation happens.

eV: How can individual investors gain exposure to frontier markets and what should they know before choosing a fund?

AG: The main frontier ETF is Blackrock's Frontier 100 under the ticker FM which follows MSCI's Frontier Markets Index. The key thing to be aware of is the problem of concentration. The index is based on size and liquidity, with 67% of the index in the top five countries. This means that, rather than getting the broad exposure to

African consumer companies or Asian growth stories that most investors want, one gets mostly banks in fairly wealthy countries. Any large investment vehicle in frontiers will have the same problem.

The number of American Depository Receipts for frontier companies is minimal so it is hard to assemble one's own portfolio. Accredited investors can chose a mid-sized actively managed fund but so far there isn't a good solution for smaller retail investors.

eV: What is your near-term outlook for frontier markets overall?

AG: We tend not to have a uniform outlook on frontiers as an asset class except at the extremes: optimistic periods when capital is flowing to risk assets generally, as it has this year, versus periods of global risk aversion when all risk assets sell off. More routinely, frontier markets move individually rather than as a class. Global themes like rising U.S. interest rates or a slowing Chinese economy don't impact them uniformly if at all. Hence, the work is in identifying which countries and regions are set to take off and rotating the portfolio accordingly.

For example, whereas Middle East markets have drifted, Asia has been the big winner this year. Vietnam is up 43%, Bangladesh 25% and Mongolia 88% in local currency terms. Yet proving that country selection is key, Pakistan is down 16% after a strong multi-year run and upgrade to emerging markets status. We feel most of Asia is expensive now but are seeing more opportunities in Eastern Europe and Africa. We also can rotate into fixed income if equity markets look pricey.

eV: Which countries interest you most right now and why? Where are you currently finding interesting opportunities?

AG: Although the market is better for direct investing, we are becoming more optimistic about Iraq. This is not only due to the push-back of ISIS but also because we see a nascent sentiment change among Iraqis that we hope will be reflected in the May 2018 elections. Governments in the Middle East are perennially worried about domestic splits along religions lines, particularly in Iraq which has an equally divided population among Sunni, Shia and Kurds. The current government, seeing the rifts growing wider, has put more effort into creating a sense of national identity rather than just a religious one. It is still very early, but the next elections may bring less sectarian politicians to parliament and allow foreign investment to ramp up. Real estate will be one of the early beneficiaries but we hope there will be opportunities in consumer and industrial businesses as well.

Staying on the Middle East theme, we also have been watching Saudi Arabia closely. After the collapse in oil prices in 2014-15, the normally expensive stock market sold off and now is as cheap as I have ever seen it. The new leadership seems keenly aware that a country where half of the population is under 30 years old cannot continue with its deeply conservative social model. Allowing women to drive, some cinemas to open and men and women to have more social interaction is a profound change for Saudi society. It goes along with an economic opening that should generate greater investment opportunities in sectors such as tourism.

More tactically, Saudi Arabia is slated for upgrade to emerging markets status next year. While other frontier countries nose-dived after their upgrades, this was in part due to their size: they constituted such a small percentage of the emerging markets index that EM funds didn't need to buy them and locals were left holding expensive stock they didn't want. Saudi Arabia, conversely, should be around 2.5% of the index excluding the Saudi Aramco IPO, placing it among the top ten index components, and should attract more international portfolio flows.

eV: How does your portfolio allocation change when a country is upgraded from a frontier market classification to the emerging markets index?

AG: The recent upgrades of several countries by MSCI from frontier to emerging markets status has been a problem for index-tracking funds but not for hedge funds. Dubai, Abu Dhabi and Qatar were upgraded in 2014, followed by Pakistan earlier this year. Argentina, Kuwait and Vietnam should be next in line. The four countries upgraded most recently deleted around 25% of the market cap from the frontier index at the time. The next three represent almost half of the market cap and 70% of the average daily value traded of the current index. If all three are upgraded, that would leave Nigeria and Morocco as the largest components, but together they only trade around US$20mn per day.

We expect the large index-trackers to modify their strategy to include former frontier countries with small weightings in the emerging markets index. Most frontier hedge funds do this already. There are eight countries on the emerging index with a weighting of less than 1% that are often included in frontier portfolios. Emerging market funds often won't bother to allocate to them, so they can stay in a frontier portfolio without causing style drift.

We are not beholden to the index so haven't encountered any problems investing in the countries we like best on a return basis. Our universe is nearly double the size of the index (50 countries versus 23) so we have more options than the indexed funds. There are also a fair number of frontier companies, mostly in the resource sector, with direct listings in London or other developed markets.

In addition, if a country looks and behaves like a frontier market, we'll keep it in our universe. One example is Egypt, which is on the emerging market index. The country went through the Arab Spring, an Islamist takeover of government through elections, more protests, a countercoup, a maxi devaluation and lots of other volatility. Since it still feels like a frontier market, we can take some exposure now that the situation is improving.

We are very keen on frontier fixed income as an asset class. The trick is to find the handful of countries whose debt is mispriced at any given time. Right now, one can get 15-18% local currency yields on Egyptian and Nigerian treasury bills with relatively stable currencies and improving economies. The yields are high due to government monetary priorities rather than default or depreciation risk.

eV: What about the credit markets in frontiers? Emerging market debt has been in the news but we don't hear much about frontier fixed income.

AG: We are very keen on frontier fixed income as an asset class. The trick is to find the handful of countries whose debt is mispriced at any given time. Right now, one can get 15-18% local currency yields on Egyptian and Nigerian treasury bills with relatively stable currencies and improving economies. The yields are high due to government monetary priorities rather than default or depreciation risk.

Yields are higher in Ghana, for example, but the currency is much weaker and economic reforms are slower. Conversely, in most of the Middle East and Central Europe, yields are less than 4% which isn't what most investors want from their frontier exposure. So there are terrific opportunities in frontier fixed income but one has to know the local treasury and currency markets well and be highly selective.

eV: What are the challenges of investing in fixed income securities in the frontier markets?

AG: Voltan invests in both equity and debt which is unusual. Most frontier funds are pure equity and to the extent that foreigners trade frontier debt, it tends to be small allocations within much larger emerging market debt portfolios.

Although frontier debt markets generally are more liquid than equity markets, there are two main challenges to frontier debt investing. With dollar-denominated sovereign debt, the yields often are driven by fund flows rather than an astute assessment of risk, such that sharp sell-offs can happen any time political risk rises. Dollar sovereigns are more often held by foreigners so can be influenced by global risk sentiment even though the underlying credit remains solid. This is more of a problem in large emerging markets, but as EM debt funds delve into the more exotic frontiers, the problem can spread to certain benchmark frontier credits.

We focus most often on local currency treasuries. Here, volatility and default rates are low but one has to select carefully based on predicted currency moves. Yields that are great for the local institutions that hold most of this debt might not make sense for us. Nonetheless, across fifty countries, we can almost always find local credits with dollar-equivalent yields over 10% whose risk is much lower, in our view, than a U.S. corporate trading at the same rate.

eV: What is your view on interest rate policy in developed markets and how this could impact the frontier markets?

AG: We see little impact because there is almost no transmission mechanism from global to local rates. Most frontier countries have low debt to GDP ratios and borrow more in their own currency than in dollars. Local banks are funded by deposits rather than international wholesale borrowing. So local interest rates are determined mainly by central banks' attempts to control inflation rather than by U.S. Federal Reserve decisions or lending rates of foreign banks. There is some connection to U.S. dollar moves – a stronger dollar means more expensive imports hence higher inflation and potentially higher local rates – but this effect usually gets washed out by other economic factors. Even when capital exits larger emerging markets based on U.S. rate increases, we don't see the same in frontiers since most debt is held by local institutions.

eV: What advice would you offer our readers currently working in investment management or interested in breaking into the industry?

AG: For someone who is interested in frontier markets specifically, I would recommend living in in a frontier country and working for a local company for a few years. You gain knowledge that you'll never acquire from behind a desk in New York or London. Even though most companies will have English-speaking executives, foreign language ability also is critical.

In terms of a career in investment management more generally, I would say one should always be learning something new. It gets more critical the longer you are out of school. Once you are confident in your expertise, it takes effort to ask yourself what you don't know and how you can learn what people twenty years younger are learning now.

eV: What should investment professionals be reading these days?

AG: First, read history. Being able to put events into their long-term context is vital in any career. As an example in emerging markets investing: when Russia became involved in Syria, most commentary referred to Russia's need to protect a small port in Syria used by the Russian navy. That single present-day fact doesn't begin to take account of Russia's 200 years of involvement in the Middle East and its wider geopolitical goals, also borne of long history. The same is true of the recent arrest of princes and business people in Saudi Arabia. There is much more to it, related to demographics and how Saudi Arabia was created as a state, than a simple power grab by a recently anointed price. This applies to domestic politics as well. It is hard to assess how events will play out and over what time period unless we really understand where they come from.

Secondly, read news from sources you disagree with. Especially working in a white collar career in New York, it is easy to get out of touch with how the rest of the country views the world or to dismiss their outlook as uninformed. It is useful every once in a while to read views different from our own and to restate them as valid arguments even if we still disagree.