THE WALL STREET JOURNAL.
WSJ.com

June 1, 2014, 6:00 PM ET

Investors Rewarded for Trek Into Little Known Markets

ByDan Keeler

An investor at the Karachi Stock Exchange. Pakistan's market has risen 88% since the start of 2013.

Reuters

Investors who ventured into frontier markets—the smaller, lesser-known cousins of emerging markets—have been rewarded with impressive equity returns over the past 18 months.

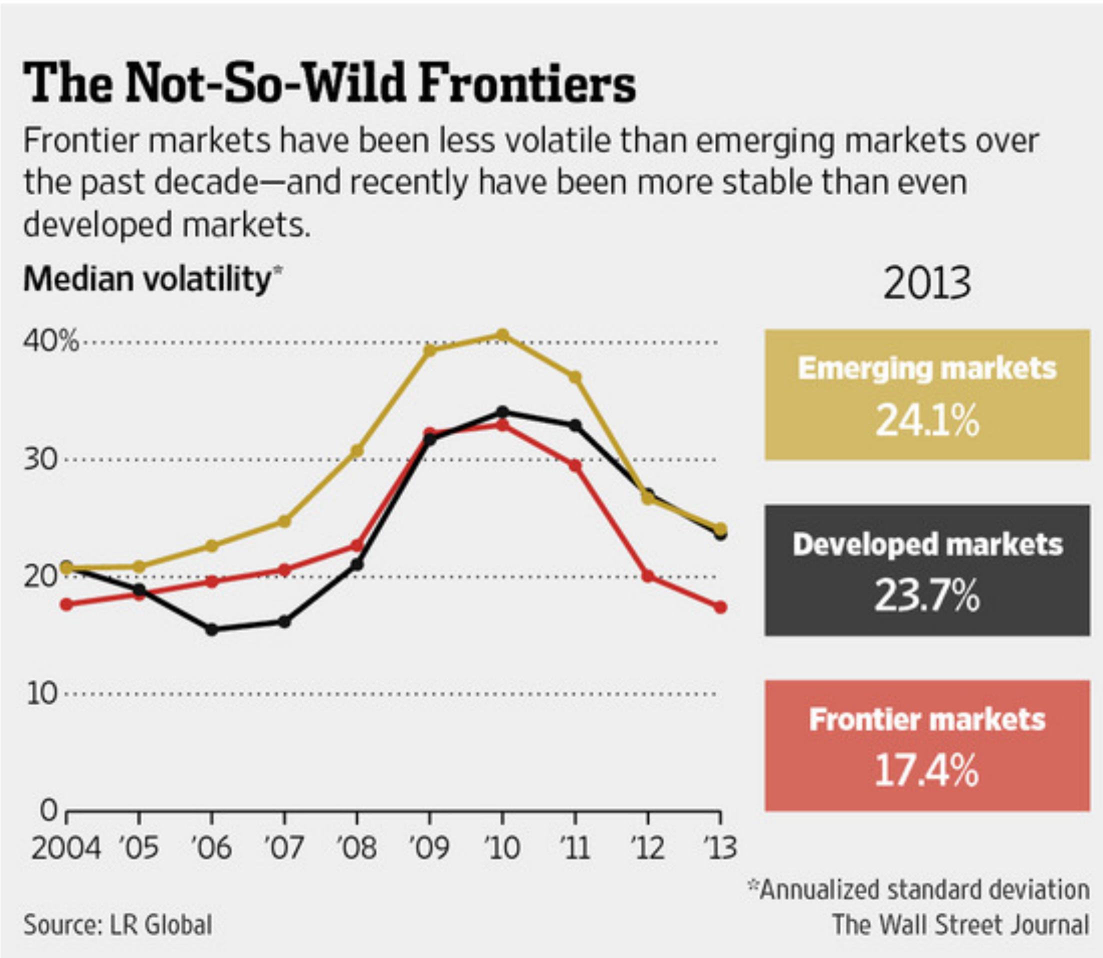
While the MSCI Emerging Markets Index has been essentially flat since the start of 2013, the MSCI Frontier Markets Index has shot up by more than 50%. Developed markets grew strongly too, but the 32% surge in the MSCI World Index was still dwarfed by frontier markets' growth.

Individual countries have posted some significant returns, too. Since the start of 2013, Bulgaria's market has soared 91%, Pakistan's has jumped 88%, and Nigeria's has risen 47%. The strong performance is helping frontier markets—usually defined as countries that have a stock exchange but don't meet the size and liquidity requirements to be in the emerging-markets index—to gain more acceptance in the investment community.

Data from EPFR Global show that funds focused on frontier markets saw inflows of more than $1.5 billion in the first four months of this year. Since the start of 2013, the funds have attracted $5.6 billion.

There may be more good news: New research shows that frontier markets, often tagged as risky and unstable because of political and economic factors, may be less volatile than commonly assumed.

A previously unpublished study by the New York-based fund manager LR Global, released by the firm in late May to selected clients, looked at the weekly returns, in U.S. dollars, of 80 stock-exchange indexes across developed, emerging and frontier markets in the 10 years to the end of 2013.



The research showed that frontier markets' stock indexes were significantly less volatile than emerging markets and slightly less bumpy than even developed markets.

LR Global, which has $200 million under management invested in frontier markets, defined volatility as the annualized standard deviation of stock-market returns. Standard deviation, which LR Global measured on a weekly basis, is a measure of how much the market swings up or down. The higher the standard deviation, the more volatile the market.

Brent Clayton, a portfolio manager at LR Global and one of the report's co-authors, acknowledged that he was surprised by the results. "We had an inkling from looking at the indices that frontier markets would be less volatile than emerging markets, but we were shocked to find that not only was that clearly the case, but also they were less volatile than developed markets over most periods."

Mr. Clayton attributes frontier markets' low volatility partly to their limited exposure to the global financial system. In a panic-driven flight to safety, investors tend to bail out of emerging markets. Frontier markets, because they have seen lower inflows of foreign capital, have generally been less affected by such moves.

“These are markets that are primarily driven by local investors and avoid the whims of shorter-term-driven foreign capital flows,” Mr. Clayton said.

Alison Graham, chief investment officer of U.S.-based frontier-markets hedge fund Voltan Capital Management LLC, said another reason for the frontier markets’ relatively low volatility is that the countries’ economies and market drivers are so diverse. “Individual countries can be quite volatile, but as a group there is a much lower correlation between them so when you blend them together in a portfolio you get much lower volatility,” she said.

Emerging markets’ economies are also similarly diverse, but the performance of their stock exchanges tends to be more correlated because they are more dependent on global fund flows and they are more likely to be connected to each other by trade and financial ties, Ms. Graham explained.

Ms. Graham cited Mongolia as having experienced the sort of volatility that can be typical of individual frontier markets. Over the past five years, Mongolia’s leading stock index rose from just over 4,600 points to a peak of more than 32,500 and recently back down to around 15,000.

Ukraine has been on a similar ride, rocketing up from less than 1,000 points to almost 3,000 points and then plunging back to around 800 points in May 2013. Since November when Ukraine’s current turmoil began, the stock index has risen almost 40%. On Friday, the index closed at 1,220.89.

Not surprisingly, Ukraine is one of four frontier countries among the 10 most volatile markets in the world. The other three are Romania, Argentina and Kazakhstan. Five of the top 10 were emerging markets and the most volatile country of all was Iceland, a developed market that suffered especially badly during and after the financial crisis.

The least volatile of the 80 markets in the study was Trinidad and Tobago, one of nine frontier markets in the top-10 least volatile. The U.S. came in at No. 11 in the least-volatile ranking.

Nikhil Bhatnagar, a vice president at frontier- and emerging-markets brokerage Auerbach Grayson & Co., said that as frontier markets continue to attract new foreign investment, particularly through index-tracking funds such as exchange-traded funds, it is likely that volatility will increase.

A rise in volatility may not be a bad thing, though. Hedge funds, particularly, look for opportunities in times of extreme market movements.

As Vietnam's stock markets plunged by 15% between early April and mid-May this year, for example, foreign fund managers were buying what they viewed as undervalued stocks. "We've been buying into the weakness," said Asha Mehta, portfolio manager of Acadian Asset Management LLC's $320 million frontier markets fund.

In Vietnam’s case, it is local investors, alarmed by their country’s deepening rift with China, who are dumping shares in local companies.

Rod Berens, co-chief investment officer of New York-based fund manager Berens Capital Management LLC, which manages $1.3 billion with a primary focus on frontier and emerging markets, believes such moves present great opportunities: “Frontier serves up cheap to very cheap stocks when participants are experiencing the pain of underperformance,” he notes.