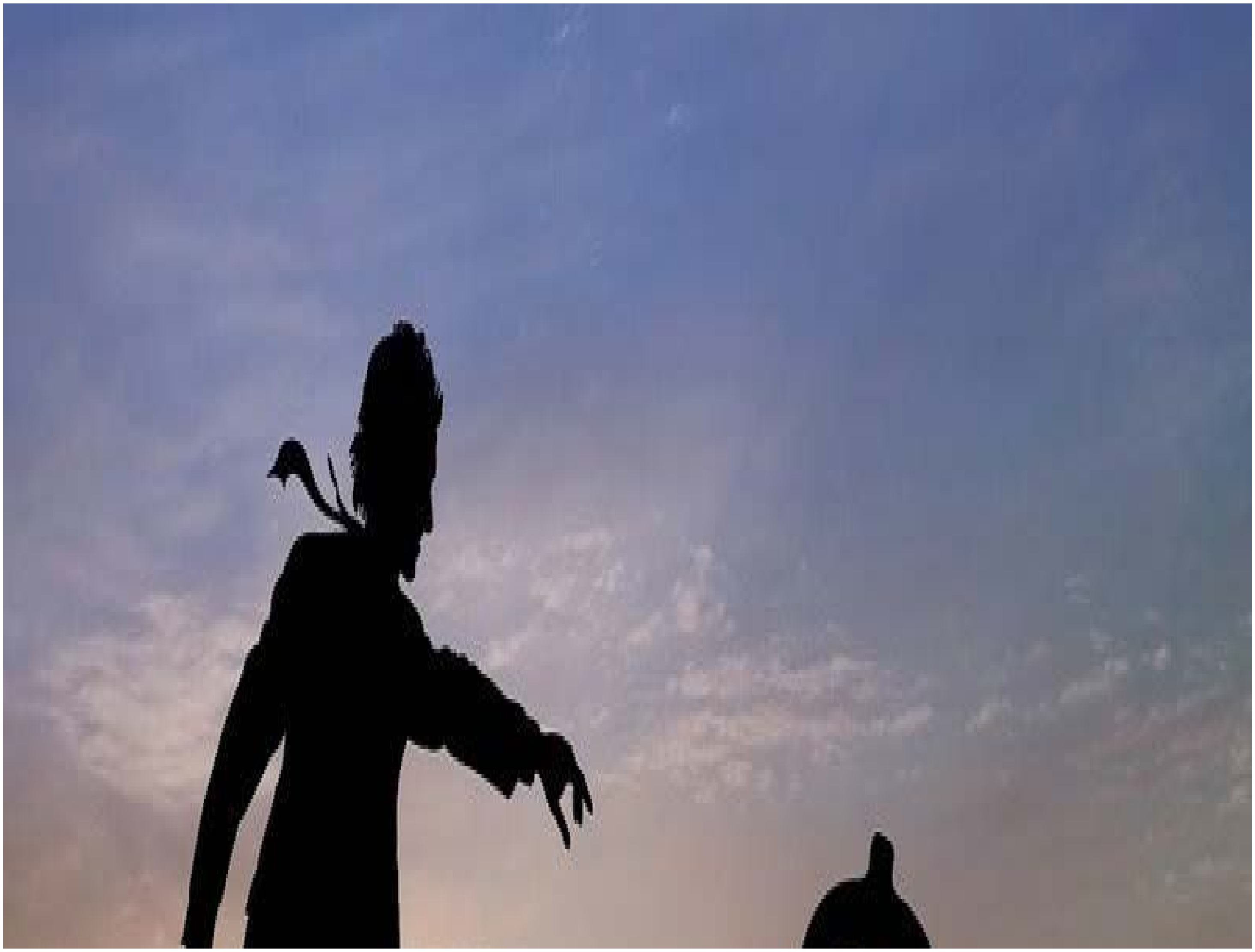
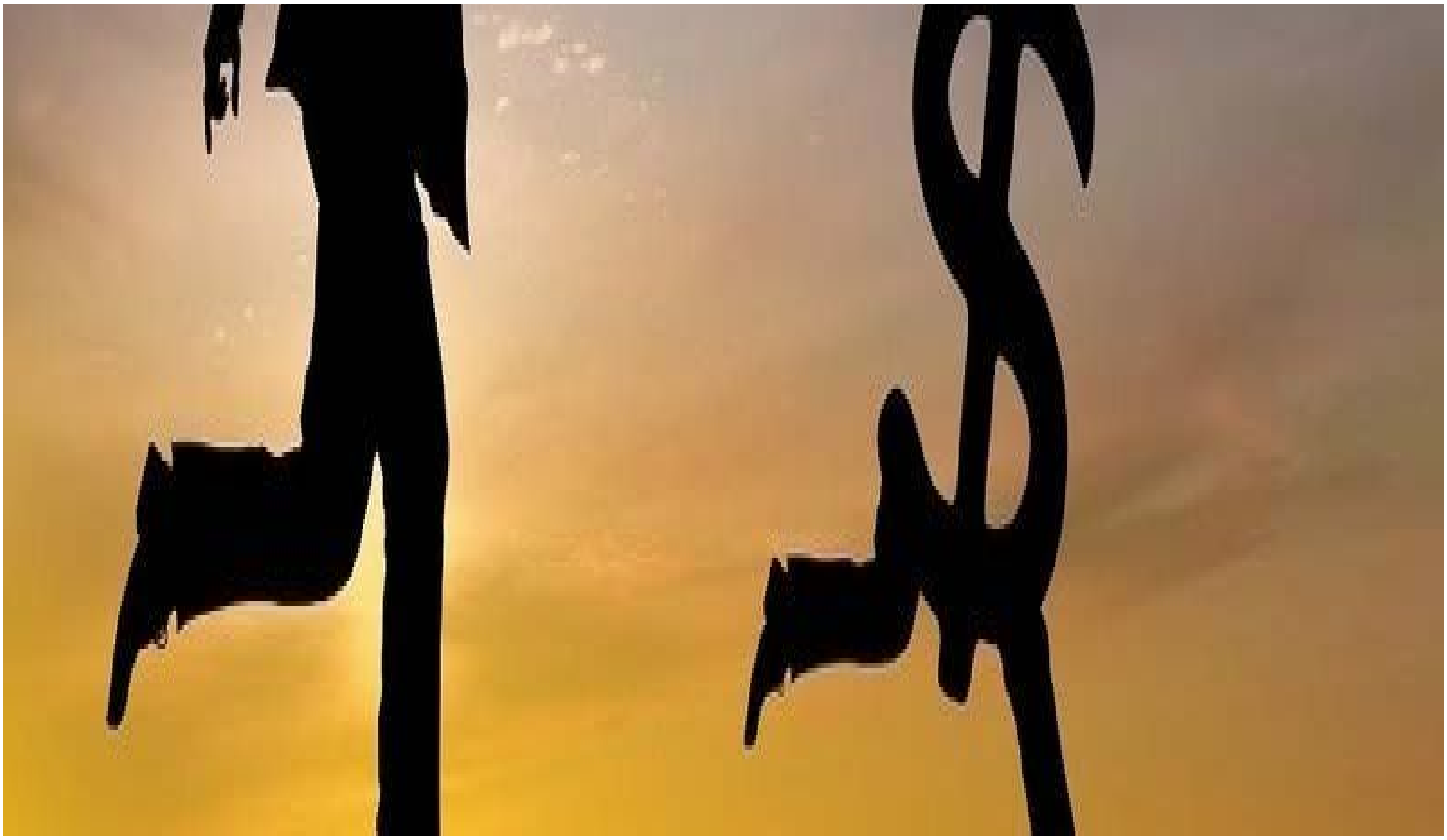
How to invest in frontier markets

If you're not afraid of a little risk (okay, a lot of risk), markets in places like Kazakhstan, Zimbabwe and Ghana are on a tear

Sep 6, 2017 @ 12:38 pm

By **John Waggoner**





In the normal course of a bull market, investors push up shares of big, stable companies. As those prices get steeper, they send mid-cap stocks soaring and then, before you know it, a small-cap **ant farm** supplier is the top-performing stock of the year.

After that, things start to go badly.

The same often holds true with international stocks. Investors fall in love with stocks in large, developed countries like the United Kingdom and Germany and then, as those markets heat up, start dipping their toes in emerging markets. And when Brazil and China look overcrowded, suddenly you hear about the great opportunities in **potassium from Kazakhstan**.

Are we at that point yet? The markets seem to be pointing in that direction. The Kazakhstan stock market, for example, has jumped 39.12% this year, vs. 12.16% for the Standard & Poor's 500 stock index. Ghana's stock market is up 71.97%, and Zimbabwe's market has rocketed 90.96%.

The overarching argument for frontier markets is that life is generally improving globally, especially for those in some of the least-developed areas. It's not unusual to see Masai goatherds in Tanzania, for example, chatting on a cell phone instead of talking to their goats. And it's not just country folks who are prospering. "I visited a Kenyan bank that I've been following for a long time, which used to be a plain-vanilla, bricks-and-mortgage place," said Carlos Hardenberg, senior vice president and managing director at the Templeton Emerging Markets Group. "Now 80% of their transaction business is online. They're just as sophisticated as any **U.S. bank**."

One reason for that improvement in the quality of life is that many frontier economies are upgrading from producing raw materials to light manufacturing. "I'm old enough to remember when those things were made in Taiwan or Japan," said Adam Kutas, manager of Fidelity adviser EMEA fund (FIEMX). "That business moved to South Korea and China, and now they're in Vietnam, Cambodia and Pakistan." Some sophisticated industry is moving to frontier markets as well: European automakers, for example, have shifted some manufacturing to Morocco and Turkey.

Other arguments are compelling as well. The first is valuation. The MSCI Frontier Markets Index has a price-to-earnings ratio of 15.05, vs. 20.02 for the MSCI All World Country Index.

The U.S. bull market has diverted a great deal of investors' attention in the past eight years, Mr. Hardenberg said, but that's ending. "There's a realization among institutional investors that the exposure they have to the U.S. and other developed markets in Europe is coming at a high price."

Typically, big flows to small frontier markets are like filling a Pepsi bottle with a firehose. So far, at least, those flows have been modest. "Retail investors have been more cautious than they were in the past," said Mr. Hardenberg. But institutional investors in Europe and Japan have been ratcheting up their frontier markets investments. "The flows have been pretty well absorbed by the markets," said Oliver Bell, portfolio manager for T. Rowe Price. "I think we're at the beginning of the next wave of interest in frontier markets."

And frontier markets have relatively low correlations to developed markets, and fairly little correlation with each other. "People in Argentina don't care what happens in Vietnam," Mr. Bell said. And, he noted, there's very little passively managed index money in the frontier markets.

What could go wrong? Plenty. Start with political risk. The Kenyan stock market, for example, has fallen 6.72% this month, rattled by a court order that nullified its presidential election. "About 40% of the return in frontier markets is from stock selection, and another 40% is from country selection," Fidelity's Mr. Kutas said. And, like **emerging markets** 30 years ago, frontier markets can be opaque and riddled with corruption. On the other hand, other frontier markets improve in the world's eyes. "Everyone loves **Vietnam** now," Mr. Bell said. "It's the consensus buy in frontier Asia."

The best way to explain frontier markets to investors, Mr. Kutas said, is to compare them to small-company stocks. "Developed markets are lower growth, but they have lower volatility," he said. "Frontier stocks can be much higher growth, but with higher volatility." The MSCI Frontier Markets index, for example, has a five-year standard deviation of 11.56, vs. 9.99 for the MSCI ACWI index. And its worst drawdown during the financial crisis was 67%, vs. 58% for the AWCI Index.

The big mistake investors and advisers make about frontier markets is that they feel that they are lowering their risks by investing there, said Kashif Ahmed, president of American Private Wealth LLC. "Folks are betting that frontier markets are where emerging markets were many years ago, but make no mistake: This involves taking on risk to a much higher level. Most folks can't even place these countries on a map, let alone know much about them to assess the investment opportunities. They are simply chasing performance."

In short, a little bit of frontier markets can go a long way. Many times, an astute emerging markets manager will add enough to satisfy your appetite for frontier-market risk. T. Rowe Price Emerging Markets (IEMFX), for example, has modest portions of its portfolio in Peru and Chile, as well as the United Arab Emirates. You'll simply have to dig into your fund's holdings to find out how big the exposure to emerging markets are.

There are just three dedicated frontier markets funds: Guggenheim Frontier Markets ETF (FRN), Global X Next Emerging and Frontier ETF (EMFM) and iShares MSCI Frontier 100 ETF (FM). Like their open-ended cousins, they tend to be more expensive than typical emerging markets funds, which, in turn, tend to be pricier than international funds generally. The Guggenheim offering is the cheapest of the three, and not coincidentally, has the highest year-to-date return, too: a 24.55% gain.

The comparison of frontier markets to small-company stock funds is an apt one. As an adviser, you know that time is the best cure for volatility, and that holding a small-company stock fund or an emerging markets fund can be lucrative in the long run. It's an easy argument to make when the fund is up more than 20% in less than a year. It gets much more difficult when the market is down 20%.