Investing in Frontier Markets

What are Frontier Markets?

- The term "frontier markets" was first proposed by the International Finance Corporation in 1992
- Frontier markets are countries with small, unstable and underdeveloped economies undergoing multiple economic changes
- Most frontier markets still experience significant problems and have lower levels of economic indicators than emerging markets
- These markets tend to be very risky and illiquid because of their general political and economic instability

What are Frontier Markets?

In the commonly used classification system, countries generally fall into two categories, developed and developing (or emerging). Developed countries have stable economic and political systems, strong levels of industrialization, and healthy economic indicators (such as gross domestic product and income per capita). Emerging countries have weaker economies and lower economic indicators, but they are making significant progress toward becoming like the stronger, developed markets. Still, countries remain that don't fit into either category, making the need for a third category apparent. These economic leftovers are called "frontier markets."

The International Finance Corporation, a division of the World Bank, first established the term "frontier markets" in 1992 to designate countries in the third category mentioned above. The assumption is that these countries still have a long development process ahead before their economies can approach what we call "emerging," but what makes them attractive is precisely the potential for growth during that future development process. From an investor's perspective, these markets are very risky and illiquid because of their political and economic instability, but they also have the potential to grow quickly and are usually in need of foreign funds in multiple areas, such as infrastructure, health care, and residential or commercial real estate.

Frontier-Market Constituents
Regional and country breakdown

- **Central & Eastern Europe & the Commonwealth of Independent States**

Bulgaria	Romania
Croatia	Serbia
Estonia	Slovenia
Kazakhstan	Ukraine
Lithuania	

- **Middle East & Africa**

Bahrain	Kenya
Jordan	Mauritius
Kuwait	Nigeria
Lebanon	Tunisia
Oman	
Qatar	
United Arab Emirates	

- **Asia & The Americas**

Pakistan	Argentina
Sri Lanka	Trinidad & Tobago
Vietnam	

Frontier-Market Constituents

As of December 2009, MSCI Barra identified 25 countries as frontier markets. They include many countries in Eastern Europe and in what used to be the Soviet bloc, such as Romania, Bulgaria, Kazakhstan, Lithuania, and the Ukraine. In Africa, frontier countries include Kenya, Mauritius, Nigeria, and Tunisia, while in Asia and the Middle East some examples are Jordan, Kuwait, Lebanon, Pakistan, Sri Lanka, the United Arab Emirates, and Vietnam. However, keep in mind that different sources may have different classification criteria and may identify different countries as frontier markets.

The Opportunities and Risks of Frontier Markets

Opportunities

- Young economies
- Strong demand for foreign investment
- Potential for industrial and business growth
- Potential for consumer growth
- Sector-specific opportunities
- More options available for indirect investment

Risks

- Currency
- Political and social instability
- Illiquidity
- Investor restrictions
- Taxes
- Poor information flow
- Poor corporate governance
- Corruption (political and corporate)

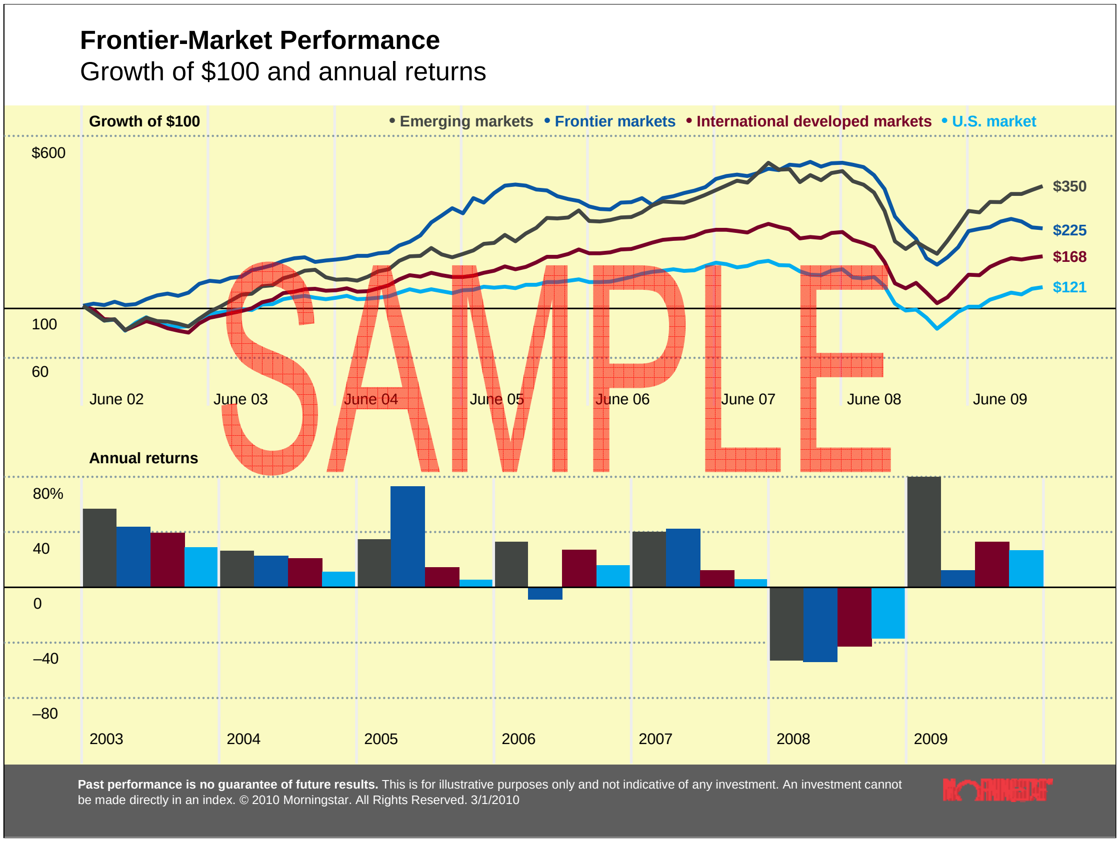
The Opportunities and Risks of Frontier Markets

Frontier markets are usually small, young economies with significant potential for expansion in multiple areas. They tend to have continuous demand for foreign investment because they have few or insufficient resources of their own. For example, in many of these countries, funds are needed in order to build infrastructure, like roads and highways, or for urban planning and development. Some frontier countries have vast rural areas in need of basic utilities like water or electricity. Sector-specific opportunities exist in areas such as health care, medical research, information technology, education, real estate and many others. All these create the potential for industrial and business growth needed to attract investors.

Investing in frontier markets directly can be a difficult process. An American investor cannot simply go and buy a bunch of stocks on the Jordanian stock exchange, for example. Nowadays, however, more and more options are available for indirect investment, such as domestic frontier market mutual funds. These funds now give American investors the opportunity to enjoy the benefits of frontier market investing without the many hassles that usually go with it.

In addition to their potential for industrial and business growth, another interesting trait of frontier markets is their potential for consumer growth. As these economies shift toward a capitalist, free-market approach, they also experience many social and cultural changes. Many refer to these countries as undergoing a process of “westernization”, meaning they tend to acquire the characteristics of western, more developed economies. As they do so, different groups of consumers are born, with new demands and socio-economic profiles, and as a consequence most of these economies witness growth in consumer spending. This process is similar to the one undergone by emerging countries like China and India; many multinational companies recently saw a large part of their profits coming from these previously neglected consumer markets. Similarly, as demand for western goods rises in frontier markets, more opportunities for export or local production may offer attractive returns on investment for those courageous enough to take advantage of these opportunities.

Speaking of courage, frontier markets are not investments for the faint hearted. With all their potential for growth, these countries are often politically and economically unstable, prone to sudden shifts in power or currency crises, various restrictions, corruption, illiquidity, and poor information flow. Take, for example, the wave of anti-communist revolutions that swept most of Eastern Europe in 1989, the Argentine economic crisis of 1999–2002, the 2009 refugee crisis in Pakistan or the ongoing conflicts in the Middle East. Due to all these factors, the economic environment of frontier markets remains very risky, and it is important that investors research and understand the opportunities and the risks before making any investment decisions.



Frontier-Market Performance

Frontier markets are a relatively new investment category. Since these markets are, by their very nature, less transparent than developed markets, access to information is limited and data is not readily accessible. Still, the data available, however incomplete, may provide valuable insights into the past behavior of these markets and into their potential future performance.

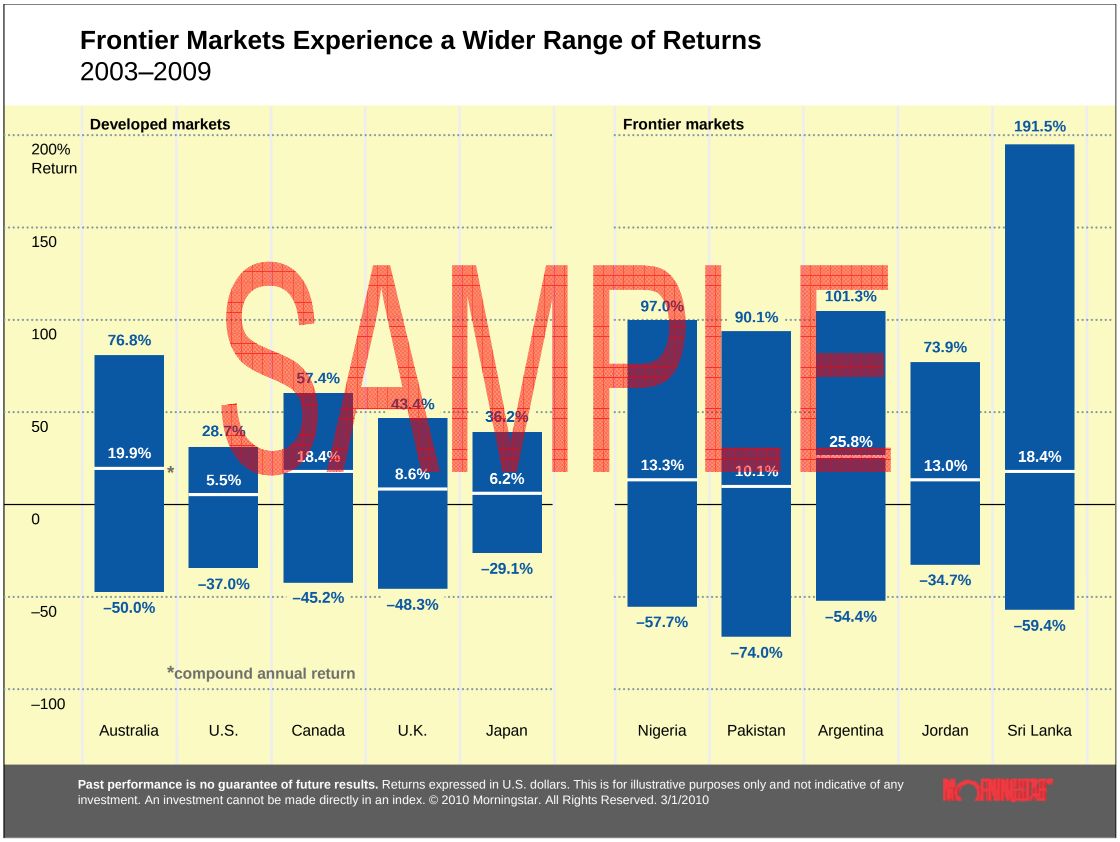
The image illustrates the growth of $100 invested in frontier markets, emerging markets, non-U.S. developed markets, and the U.S. market from June 2002 through December 2009. Emerging markets provided the highest return and the largest ending value during this time period, followed closely by frontier markets. International developed markets provided a decent return, but lagged behind their less-developed counterparts. Out of all four investments, the U.S. market performed the worst during the time period analyzed.

The bottom chart displays annual returns for the four asset classes analyzed since 2003. Frontier markets had an excellent year in 2005 and were again the top performer in 2007, but their negative performance in 2006 and 2008 largely offset previous gains. This illustrates the elevated risk of frontier markets, which can also be seen from the line fluctuations in the top graph. These markets may promise higher returns, but any potential investors should also carefully consider the elevated risk levels that invariably come with these higher returns.

Returns and principal invested in stocks are not guaranteed. International investments involve special risks such as fluctuations in currency, foreign taxation, economic and political risks, liquidity risks, and differences in accounting and financial standards. Frontier-market investments are riskier than developed- and emerging-market investments.

About the data

U.S. stocks are represented by the Standard & Poor’s 500®, which is an unmanaged group of securities and considered to be representative of the stock market in general. International developed stocks are represented by Morgan Stanley Capital International Europe, Australasia, and Far East (EAFE®) Index. Emerging market stocks are represented by the Morgan Stanley Capital International Emerging Markets Index, and frontier market stocks by the Morgan Stanley Capital International Frontier Markets Index. The short time frame is dictated by data availability. An investment cannot be made directly in an index. The data assumes reinvestment of income and is expressed in U.S. dollars. Unlike domestic returns, foreign market returns consist of two main components: market performance and currency fluctuations.



Frontier Markets Experience a Wider Range of Returns

When frontier markets came into the spotlight as an investment possibility, their two most publicized traits were high returns and high risk (most of the time these two go together). The high returns are usually a result of these countries' growth potential, while their high risk is a reflection of their political and economic instability.

But just how risky can frontier markets get? The image illustrates the range of annual returns for five developed markets and five frontier markets between 2003 and 2009. It is evident at first glance that frontier markets have much wider ranges, meaning their returns fluctuate a lot more, which makes them riskier investments. In contrast, the ranges for developed markets are much tighter, reflecting how their returns have smaller swings in value and lower risk.

However, with added risk comes the potential for greater return. Developed markets may be safer investments, but the highest compound annual return among the developed countries (Australia, 19.9%) was significantly lower than the corresponding highest frontier return (Argentina, 25.8%). In the end, however, the middle of the road may prove to be the best choice, as a diversified portfolio of developed and frontier markets can combine the best of both worlds.

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About the data

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The Best and Worst of Frontier Markets
Annual returns compared to the U.S.

	1st	2nd	3rd	Last	
2009	Sri Lanka 191%	Pakistan 90%	Argentina 64%	Bahrain –32%	United States 26% 6th
2008	Qatar –26%	Jordan –35%	United States –37%	Pakistan –74%	United States –37% 3rd
2007	Nigeria 97%	Oman 60%	Qatar 54%	Sri Lanka –13%	United States 5% 9th
2006	Argentina 67%	Nigeria 49%	Sri Lanka 46%	UAE –47%	United States 16% 4th

Past performance is no guarantee of future results. Returns expressed in U.S. dollars. This is for illustrative purposes only and not indicative of any investment. An investment cannot be made directly in an index. 3/1/2010

The Best and Worst of Frontier Markets

Limiting investments to only the United States or developed markets can mean missing out on some exceptional returns. Historical return data for frontier markets is unfortunately limited but, even so, examining frontier-market returns for the past few years can offer some insight into how they performed compared to the U.S.

The image compares and ranks annual return data for 10 frontier countries and the U.S. in 2006, 2007, 2008, and 2009. Except for 2008, which was a year of global crisis, the top frontier performer posted impressive returns: Sri Lanka returned 191% in 2009, Nigeria 97% in 2007, and Argentina 67% in 2006. The United States ranked 3rd in 2008, but otherwise never made it to the top three for the time period analyzed, and its returns were average at best when compared to those of top frontier investments. However, always keep in mind that these higher returns come with added risk and that the downswing can be just as extreme: Pakistan lost 74% in 2008, and the United Arab Emirates declined by 47% in 2006.

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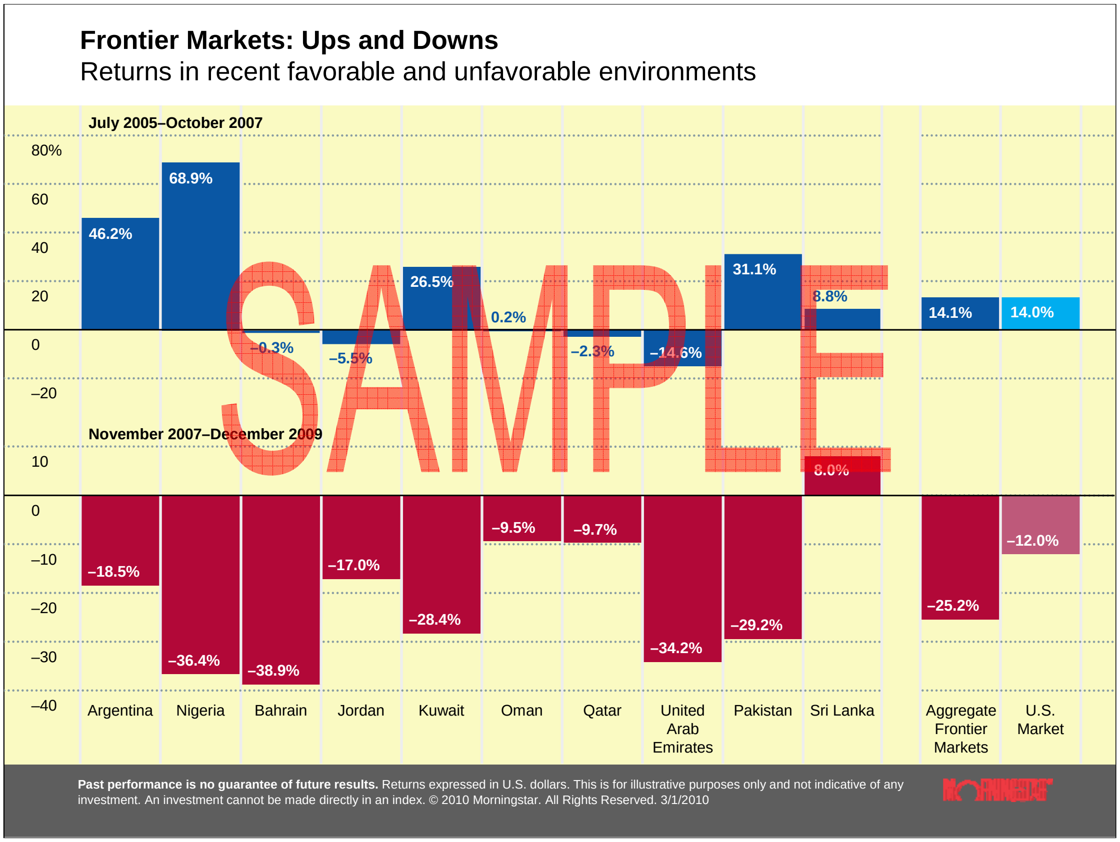

Frontier Markets: Ups and Downs

Economies and markets tend to move in cycles, with up and down markets succeeding each other in a relatively unpredictable fashion. It is not uncommon for a crisis originating in a developed economy to have a ripple effect throughout the rest of the world. The recent U.S. credit crisis and subsequent financial collapse, for example, triggered a domestic recession and had serious repercussions on other developed and developing economies alike.

Because of this type of ripple effect, it helps to study frontier markets and compare them side by side with the U.S. market in both favorable and unfavorable economic environments. The top graph presents the performance of 10 frontier markets, the aggregate frontier-market index, and the U.S. market between July 2005 and October 2007, a relatively prosperous economic period. Nigeria and Argentina performed exceptionally well, returning 68.9% and 46.2%, respectively, compared to 14.0% for the U.S. market. However, there were also a few countries with negative returns, like the United Arab Emirates and Jordan. Overall, the aggregate performance of frontier markets was very similar to the U.S. at around 14%.

In contrast, the bottom graph displays performance during the recent U.S. recession and related international decline (between November 2007 and December 2009). The U.S. trouble appears to have rippled through to the frontier markets analyzed, most of which posted double-digit negative returns, except Oman and Qatar. Sri Lanka was the only frontier market to post a surprising 8.0% positive return during this time period. Overall, the two images illustrate the elevated risk of frontier markets: In favorable conditions, they have the potential to deliver much higher returns than their developed counterparts, but the downside can be just as extreme and returns in unfavorable environments can be devastatingly low. Again, frontier markets are not for everyone, but only for investors prepared to understand and assume the additional risk they bring along with their potential for attractive returns.

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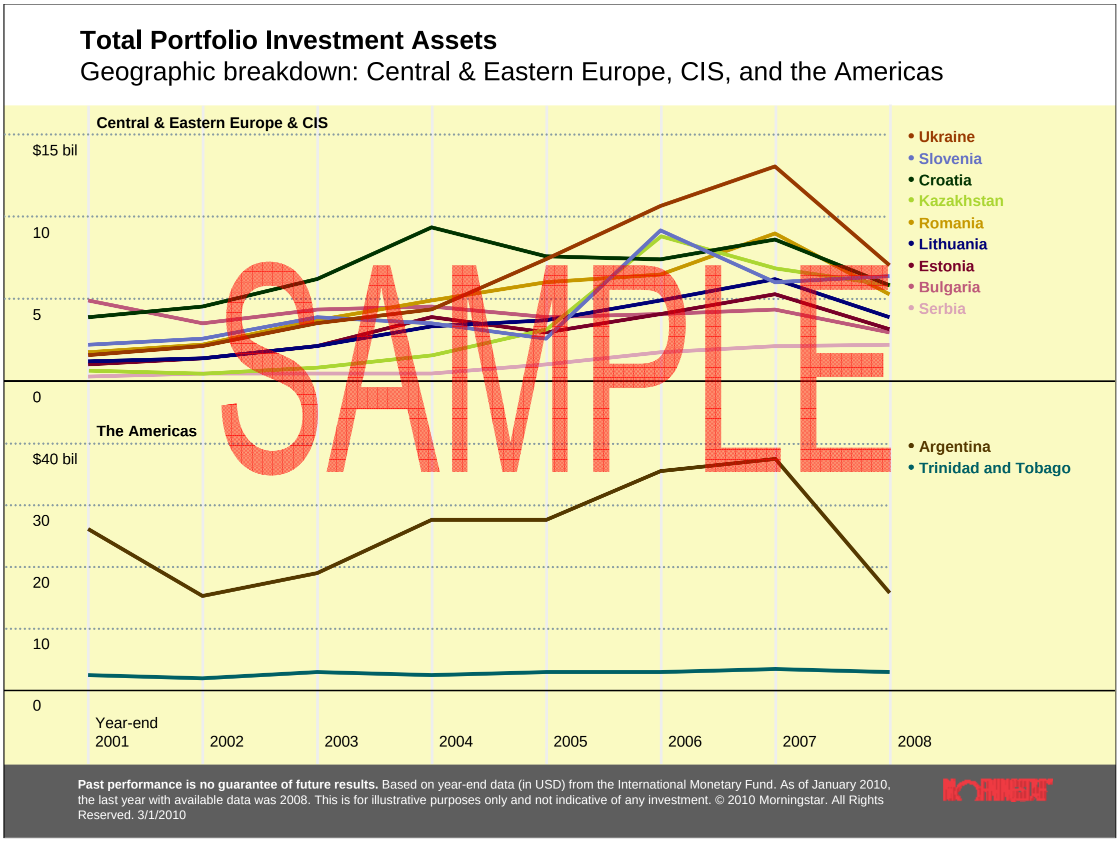
About the data

Equities for each country are represented by their respective Morgan Stanley Capital International Indexes. Aggregate frontier markets are represented by the MSCI Frontier Markets Index, and the U.S. stock market by the Standard & Poor's 500®, which is an unmanaged group of securities and considered to be representative of the stock market in general. The short time frame is dictated by data availability. An investment cannot be made directly in an index. The data assumes reinvestment of income and is expressed in U.S. dollars. Unlike domestic returns, foreign market returns consist of two main components: market performance and currency fluctuations.



Total Portfolio Investment Assets: Central & Eastern Europe, CIS, and the Americas

The International Monetary Fund (IMF) is a global organization of 186 countries whose mission is to foster global monetary cooperation, promote sustainable economic growth and reduce poverty around the world. Every year, the IMF conducts a Coordinated Portfolio Investment Survey in order to determine various economies' cross-border holdings of portfolio investments.

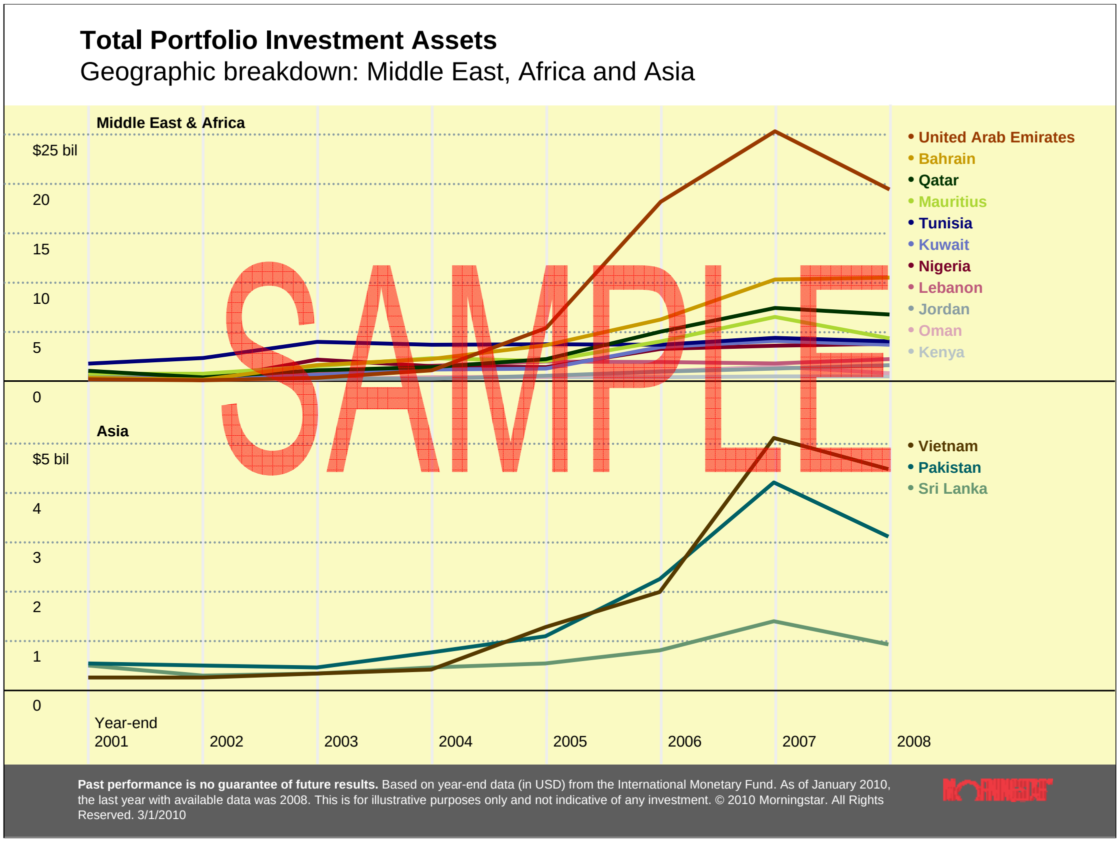
The top graph on this slide displays frontier countries in Central and Eastern Europe and the Commonwealth of Independent States (CIS), and the bottom graph displays the Americas. The encouraging trend that can be observed on both graphs is that investment in most frontier countries has generally been increasing for the time period analyzed. In Eastern Europe the Ukraine, Slovenia, Croatia and Romania have attracted significant foreign investment, while in South America Argentina has been a flourishing market.

The fact that international investment in these frontier economies has been steadily trending upward over the past seven years is encouraging. These capital inflows are probably put to good use in each country, strengthening the economy, creating new jobs, and improving the financial system. Foreign investors may enjoy handsome returns on investment, but keep in mind that by investing in these relatively young economies they are also exposed to these countries' multiple intrinsic risks.

Also keep in mind that international investments involve special risks such as fluctuations in currency, foreign taxation, economic and political risks, liquidity risks, and differences in accounting and financial standards. Frontier-market investments are riskier than developed- and emerging-market investments.

About the data

Data for total portfolio investment assets from the International Monetary Fund's Coordinated Portfolio Investment Survey, last updated December 2009. Investment assets include equity securities and long- and short-term debt securities valued at market prices prevailing at the end of December of the reference year. The short time frame is dictated by data availability. All data expressed in U.S. dollars.



Total Portfolio Investment Assets: Middle East, Africa and Asia

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The top graph on this slide displays frontier countries in the Middle East and Africa, and the bottom graph displays Asia. The encouraging trend that can be observed on both graphs is that investment in most frontier countries has generally been increasing for the time period analyzed. The United Arab Emirates stands out among Middle Eastern economies: It ranks sixth in the world in terms of oil reserves, and it has a nominal GDP per capita higher than the U.S. ($55,028 versus $47,440 in 2008). In terms of total portfolio investment assets, other promising frontier economies include Bahrain and Qatar in the Middle East, Mauritius, Tunisia and Nigeria in Africa, and Vietnam and Pakistan in Asia.

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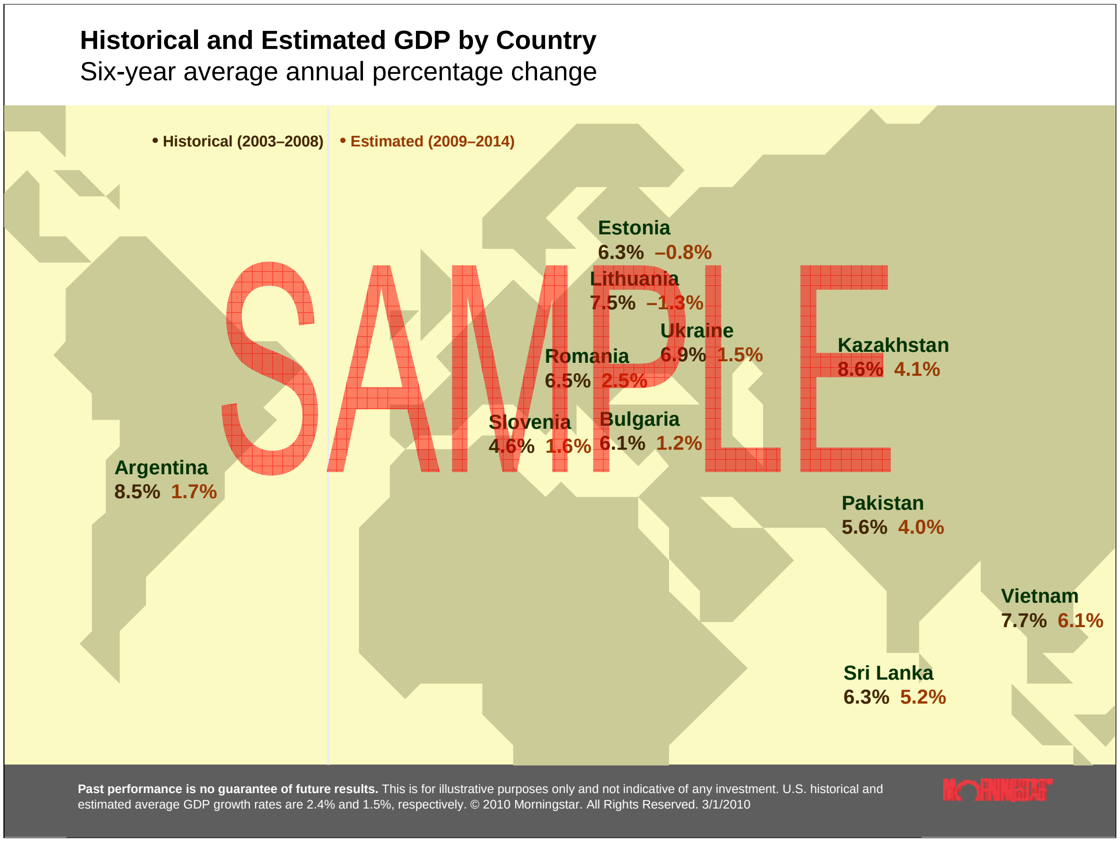

Historical and Estimated GDP by Country

Gross domestic product (GDP) is defined as the total market value of finished goods and services produced in a country within a given time frame (usually 1 year). GDP is widely accepted as a reliable measure of economic health: the higher the GDP, the stronger the economy. Growth in GDP from year to year (normally expressed as a percentage) is a useful indicator of an economy's performance over time.

The image presents historical and estimated GDP growth rates for 11 frontier countries around the world. Historical GDP growth is calculated as an average over the past six years, 2003–2008, and estimated GDP growth as an average of the estimated values for 2009–2014.

One interesting theme in the image is the significant difference between historical and projected GDP numbers for all countries. In the past, frontier economies were able to grow at a very fast pace; for example, Kazakhstan grew at an average 8.6% and Argentina at an average 8.5% over the past six years. This type of growth, however, does not appear sustainable over longer periods of time, especially in light of the recent global financial crisis. The bad news is the estimated growth rates will not be as high anymore, but the good news is they will at least be positive for most countries. Vietnam is projected to grow at an average 6.1% rate annually, Sri Lanka at 5.2%, and Kazakhstan at 4.1%, to name just a few. Even if the unusually high growth investors got used to in the past is unlikely to continue, there is still significant potential for attractive returns in frontier markets. The U.S., by comparison, has an estimated average GDP growth rate of only 1.5%.

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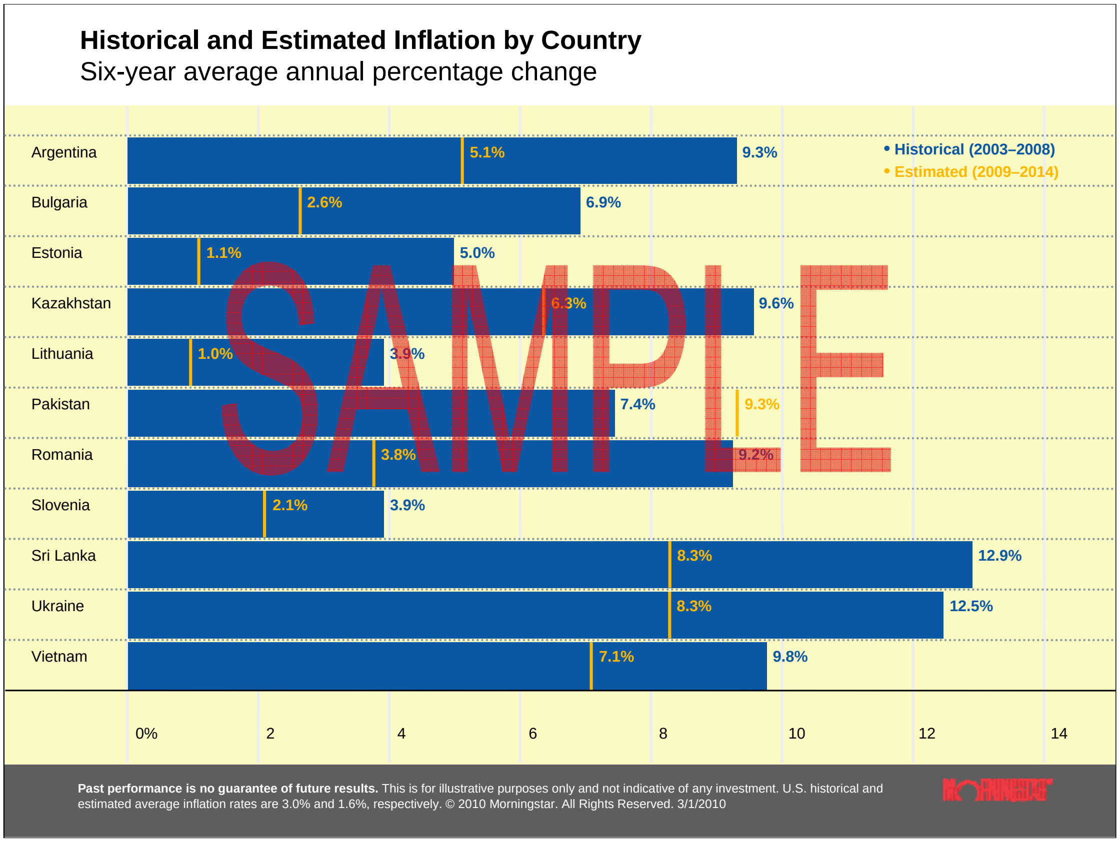
About the data

Historical and estimated gross national product data from the International Monetary Fund's World Economic Outlook Database, October 2009. All data expressed in U.S. dollars. Values were calculated as arithmetic averages.



Historical and Estimated Inflation by Country

Inflation is an important factor that needs to be considered when making investment decisions, especially in such unstable economic environments as frontier markets. High rates of inflation can generate uncertainty, lower productivity and erode investment returns. When investing internationally, it is necessary to look at a country's inflation rate in order to understand how investments in this country might be affected by it.

The image presents historical and estimated inflation rates for 11 frontier countries around the world. Historical inflation is calculated as an average over the past six years, 2003–2008, and estimated inflation as an average of the forecasted values for 2009–2014.

For all countries displayed except Pakistan, projected inflation rates are lower than historical ones, which is an encouraging thought. Most frontier markets undergo a complex development process and it may take a while for their currencies to stabilize, which is necessary for keeping inflation in check. Most of the average estimates indicate that significant progress will be made in that direction, with relatively low forecasted inflation for Lithuania, Estonia, Slovenia, Bulgaria and Romania. However, estimates for other frontier countries remain high, such as 9.3% for Pakistan and 8.3% for the Ukraine and Sri Lanka, signaling more difficulties ahead for some of these markets.

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About the data

Annual historical and estimated inflation data from the International Monetary Fund's World Economic Outlook Database, October 2009. Values were calculated as arithmetic averages.

Optimism and the Investment Outlook
Will the next generation be better or worse off?

Developed	Optimistic (% of surveyed population)
Spain	36%
U.S.	31%
Sweden	29%
U.K.	29%
Canada	28%
France	17%
Germany	17%
Japan	10%
Italy	10%

Frontier	Optimistic (% of surveyed population)
Nigeria	69%
Bulgaria	56%
Ukraine	52%
Jordan	49%
Kenya	49%
Pakistan	42%
Argentina	41%
Kuwait	35%
Lebanon	33%

Optimism and the Investment Outlook
A very interesting study by the Pew Global Attitudes Project surveyed 47 countries around the world in order to determine people's opinions, attitudes and perceptions on various topics. People in each country were asked whether they thought the next generation in their country would be better or worse off, in order to estimate the general level of optimism pertaining to the country's situation. The image compares results of the study for select developed and frontier markets, and the findings are both encouraging and surprising.

Excluding Spain, all frontier markets displayed have higher levels of optimism than developed countries. Only 31% of Americans and 28% of Canadians believe the next generation will enjoy a higher standard of living. The outlook is even bleaker in Europe, where only 17% of French and Germans are optimistic, and almost disastrously pessimistic in Japan and Italy, where only 10% of residents see a better future for the next generation. The only developed country with a "sunnier" disposition appears to be Spain, with 36% optimistic residents. In contrast, 69% of Nigerians are optimistic, along with 56% of Bulgarians, 52% of Ukrainians, and so on. Even the last frontier market on the list, Lebanon, has a higher percentage of optimists than the U.S.

What impact will these pessimistic attitudes have on the global economic environment and on the future of investment? It's hard to tell. One possible explanation could be that frontier-market optimism is due largely to currently low standards of living and people's expectations that it will improve, as opposed to pessimistic developed countries where the standard of living is already high. But as markets are continually shaped by and react to people's attitudes and perceptions, it may be tempting to assume that frontier markets present a more favorable environment for sustainable economic growth than developed markets, where negative expectations may seriously cripple future progress.

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About the data
Data from the Pew Research Center, Pew Global Attitudes Project, 2007. Keep in mind that these are survey results based on country samples and not on the entire population.