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The Case for Investing in the Frontier Markets
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by Patrick Knapp and Vikram Mansharamani, LVW Senior Advisor

Frontier Markets: As emerging markets continue to mature, frontier countries offer a compelling opportunity to gain exposure to uncorrelated growth.

Overview

When the first comprehensive emerging markets index was created in 1988, it included only 10 countries which made up less than 1% of the world market. These countries represented the El Dorado of investments: the prospect of outsized returns complemented by significant diversification benefits. Fast forward 25 years to find that this same index now includes 21 countries and nearly 13% of the world market cap.\textsuperscript{1} The two-decade evolution of emerging markets saw them shift from an opportunistic investment to a core holding in many portfolios with capital flows to match.
As the importance and popularity of the asset class has grown, its unique benefits have tempered. Correlations between emerging market countries and between the emerging markets and developed markets have steadily increased. Many emerging markets, although expanding much faster than the developed world, are also experiencing slower economic growth. We believe that emerging markets still represent an attractive asset class and should be part of a diversified equity allocation, but investors must adapt to their changing portfolio role by seeking out fresh investment opportunities with idiosyncratic characteristics and high growth prospects. We believe the logical asset class to turn to is collectively known as the frontier markets.

In the discussion that follows, we will address four key questions:

1. How is the frontier market universe defined?
2. What is the case for investing in frontier markets?
3. What are the risks of investing in frontier markets?
4. What considerations are there for accessing the frontier market opportunity?

**How is the frontier universe defined?**

While there is no set or common definition of “frontier markets,” they are often thought of as the emerging, emerging markets. Several financial information providers (MSCI, Russell, S&P, FTSE, etc.) have developed indexes in an attempt to capture the commonalities of the universe. Frontier-dedicated managers often find such definitions and indexes poorly constructed and therefore very constraining. The working definition we find most useful is any country that has a stock exchange open to foreign investors and is weighted at less than 1% in the MSCI Emerging Markets Index. In aggregate, such countries represent 20% of the world’s population, 10% of global GDP, and approximately 2% of the world’s market capitalization.
Frontier countries are an extremely diverse group in nearly every category. One of the most striking differences is the varying levels of economic advancement. For example, Qatar had the highest GDP per capita in the world as of 2012 at $103,900. Despite economic prosperity, countries like Qatar are considered frontier due to limits on foreign investment and liquidity concerns. In sharp contrast, Kenya ranked 198th in GDP per capita at $1,800 and represents the group of frontier markets that are truly infant economies.

**What is the case for investing in frontier markets?**

The case for frontier markets centers around four characteristics:

1) **Greater economic growth potential** than most other countries in the world
2) **Misunderstood and inefficient capital markets** with significant mispricing
3) **Underdeveloped financial markets**
4) **Low(er) correlation** with other asset classes than might be expected

**Growth Potential**

If history is any indicator of growth potential, emerging markets paint an intriguing picture of the growth trajectory of frontier markets from both a GDP and market capitalization standpoint. Frontier markets are at a similar level and are currently following a similar growth path to emerging markets in the late 1980s.
In 2012, the only non-frontier country in the world to be included on the list of the 30 fastest-growing economies was China. This is expected to be a prolonged trend as indicated by many forecasters. Notice in the example to the left that six of the top 10 highest GDP growth countries over the 40-year period to 2050 are considered frontier. Notable absences include current emerging market powers China, Brazil, and Russia.

Favorable demographic dynamics support forecasts that economic growth for frontier markets is likely to be strong for the foreseeable future. Countries that have a growing labor force relative to their non-working population experience significant economic tailwinds in per capita production, savings and investment rates, education rates, and positive societal shifts. This “demographic dividend” is accelerating and appears to be of longer duration among frontier countries than both their emerging markets and developed markets counterparts.

Frontier countries have outpaced more developed countries in terms of gross capital formation over the 2000-2009 time frame. When investing in capital such as infrastructure from a low base, the marginal return to GDP is much higher than developed countries as well, implying a positive outlook for economic growth in the future from such investments.
**Misunderstood and Inefficient**

Despite compelling growth characteristics, frontier markets remain off the radar screens of many global investors. This may stem from a misconception of frontier market risk relative to other asset classes. In reality, the volatility of frontier markets has been less than that of emerging markets over time.

In a world of rising government debt burdens, frontier markets also have exceptional balance sheets. Debt to GDP levels are roughly half that of emerging markets and an eighth that of developed markets. Reserve levels are also significantly higher than developed markets.

There also appears to be a significant mismatch between investor perception of country-level risks and the reality of economic freedom. The Heritage Foundation publishes its Economic Freedom Index which ranks countries based on four categories: rule of law, limited government, regulatory efficiency, and open markets. Many frontier markets not only rank higher than emerging and developed markets, but have made huge advances in economic freedom in the last 18 years.
Since 2009, frontier markets have not participated in the rally to nearly the same extent as other markets. They are still below their 2008 high by approximately 40% and trading at mid-2005 levels.
The muted rally leaves frontier stocks trading at attractive valuations complemented by a higher dividend yield than the rest of the world.

<table>
<thead>
<tr>
<th></th>
<th>MSCI World</th>
<th>MSCI Emerging Markets</th>
<th>MSCI Frontier Markets</th>
</tr>
</thead>
<tbody>
<tr>
<td>P/E – Trailing 12-month (x)</td>
<td>19.3</td>
<td>16.6</td>
<td>15.8</td>
</tr>
<tr>
<td>P/E – Forecast 12-month (x)</td>
<td>14.6</td>
<td>13.4</td>
<td>12.7</td>
</tr>
<tr>
<td>Historic Dividend Yield (%)</td>
<td>2.8</td>
<td>2.8</td>
<td>4.3</td>
</tr>
<tr>
<td>Dividend Yield FY1 (%)</td>
<td>2.7</td>
<td>2.8</td>
<td>4.3</td>
</tr>
<tr>
<td>Total Market Cap (US$ Billion)</td>
<td>28,155</td>
<td>3,728</td>
<td>123</td>
</tr>
</tbody>
</table>

Source: Factset, MSCI as at 31 May 2013
Data historic unless indicated otherwise

Lack of attention to frontier markets extends to Wall Street where frontier markets security coverage is significantly less comprehensive than that of emerging markets. The dearth of analyst coverage is symptomatic of an inefficient market that offers the potential for significant information advantages.

Underdeveloped Financial Markets
It should not come as a surprise to learn that countries like Kenya and Cambodia have significantly less developed financial and capital markets than do developed countries—as well as most emerging countries. However, there is a disconnect between the economic output and capital market structure present in frontier markets. The next figure illustrates the discrepancy. Frontier markets make up only .4% of the global market cap but 8% of the world’s nominal GDP. The differential between these numbers offers the potential for
market capitalization values to narrow the gap with GDP share as capital markets in these countries develop.

Low(er) Correlation
Investing in the frontier markets offers more than an opportunity to tap into high growth potential. Frontier markets also exhibit attractive diversification properties with low correlation to other equity markets.

Correlation post 2008 is clearly elevated in this illustration. However, when the countries that make up the Gulf Cooperation Council (Saudi Arabia, Bahrain, Kuwait, Oman, Qatar, and the United Arab Emirates) are removed, correlations decrease significantly.
We believe this difference highlights significant issues with index construction for frontier markets, which we will discuss later.

**What are the risks of investing in frontier markets?**

Investing in frontier markets is not without risk. The primary risks include:

1. Geopolitical Instability
2. Institutional Immaturity
3. Currency Instability
4. Limited Liquidity
5. Lack of Transparency, Poor Governance
6. Counterparty Risks

The most unpredictable risk of frontier markets is geopolitical instability. It is a fact that many frontier countries are located in regions that have a history of severe armed conflict and political uprisings. Even recently, the Middle East, where the largest and most liquid frontier markets are located, has dealt with the Arab Spring and its subsequent effects.

Institutional immaturity refers to the restrictions on foreign ownership that may exist in a country, the relatively young financial reporting standards, the consistent application of rule of law, and the difficulties of simple functions such as asset custody.

Currency instability is a reality of investing in small and developing countries. Governments in these countries may not have the necessary fiscal or monetary tools needed to rein in inflation should it rise to a problematic level. Currency hedging is often not an option, or if it is, it’s prohibitively expensive. Capital controls may prevent ease of investor flows, and some countries demand pre-funding of trades prior to execution—creating a structural “cash” balance that may dampen returns.
Although liquidity is improving rapidly, daily volumes are approximately $300 million when Saudi Arabia is excluded. Volume within individual countries varies widely with countries such as Slovakia representing an uninvestable extreme at a daily volume of $845. Limited liquidity generates the potential issue that once invested, it may become extremely difficult to sell shares.

Source: Frontier Market Asset Management, LLC

Transparency and corporate governance, while suspect even in emerging markets, appear to be more problematic in certain frontier markets than elsewhere. Stories abound of self-dealing, contract manipulation, and family shopping trips on corporate expense accounts.

Finally, due to capital controls and other market restrictions, foreign investors often access certain frontier markets via Wall Street generated access products such as participating notes ("p-notes") and/or swaps. This generates an additional counterparty risk that must be managed.

**What considerations are there in accessing the frontier market opportunity?**

Currently, there are a very limited number of investable index funds focused on frontier markets. This is likely due to some of the issues raised above. As the asset class becomes more developed, we expect more to be released. Regardless, active management is preferred over passive indexing in frontier markets for several reasons. The first involves the construction of currently available frontier indexes. A prime example is the MSCI Frontier Index shown below.
The construction methodology results in 68% of holdings spread across just four countries (three of which are in the Middle East) and 53% of holdings in the financial sector. This is hardly a diversified portfolio. We previously showed that by simply removing the Gulf Cooperation Council countries, we can significantly change the correlation characteristics of a frontier investment. It is our opinion that active management offers a significant portfolio construction advantage over indexes.

Part of the frontier markets thesis is predicated on country and market development. As this development occurs, we expect that countries will shift between the classifications of major index providers. Just this past June, MSCI announced that Qatar and the United Arab Emirates will graduate from the frontier index to the emerging markets index. Morocco, on the other hand, will be downgraded from emerging to frontier market status. The constant evolution of index components means that passive investors may inadvertently become non-economic sellers and non-economic buyers. We believe these circumstances create the potential to negatively impact returns. For example, a frontier country upgrade to emerging market status could lead to large inflows of capital and asset appreciation after the former frontier index had purged its shares.

Fund size is an important factor to the success of a frontier market strategy. Due to the liquidity constraints of many frontier markets and individual stocks, we believe that the maximum effective capacity for an open fund is currently approximately $1 billion. We believe frontier markets represent a long-term opportunity and so our search will focus on funds with assets under management of $100 million to $700 million with managers that clearly state their intentions to close the fund at or prior to $1 billion. This range allows capacity for our clients and room for the fund to grow. As financial markets in frontier countries develop, capacity constraints may change.

The diversity of the countries that make up the frontier market universe requires hands-on, focused management willing to travel extensively to build constructive relationships and evaluate countries and companies. In many of these countries, foreign ownership is a recent phenomenon. Cultivating local contacts or hiring consultants with a deep understanding of regional markets and modes of operation can serve as important sources for opportunities and connections. This also helps mitigate the transparency and institutional immaturity risks. These operational requirements necessitate higher expenses than most other widely investible markets.

Conclusion

Frontier markets represent a unique mix of uncorrelated growth coupled with a variety of risks. While these risks are very real and should not be understated, we believe that most, if not all, are symptoms of the early
development stage of the asset class. As frontier countries progress, these risks should decrease with accompanying opportunity for market cap expansion as a result.

The return opportunity and diversification benefit of frontier markets has led us to begin a search for an active manager to help us deploy capital into the frontier countries. In meetings with a wide range of managers—from small groups within large multi-fund asset management firms to small, single-fund boutique managers—it appears that focus and deep familiarity with underlying markets are critical to managing the risks and harvesting the rewards the frontier markets offer. We look forward to providing you with an update of our progress at our next meeting. In the meantime, please contact us with any questions.

To learn how LVW Advisors can help you achieve your highest investment objectives, please call or email Laurie Sheller at 585-267-4900 or lsheller@LVWAdvisors.com to request a consultation with one of our advisors.

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1 MSCI “Built to Last: Two Decades of Wisdom on Emerging Markets Allocations,” October 2012; market cap measured by MSCI ACWI.