

Exploring the frontiers

With sluggish economic data streaming out of the U.S., investors should start exploring frontier markets as an alternative, writes *Mark Mobius*

Emerging markets have developed gradually in the last 20 years to a stage where the biggest are more similar to mature markets. They have become a major asset class, as evidenced by a plethora of massive initial public offerings, high capital inflows, fundraising activities and the success of the BRIC (Brazil, Russia, India, China) funds.

Now, investors are turning to frontier markets – typically economies at the lower end of the development spectrum but with the growth potential to become tomorrow's emerging markets.

China, for example, was considered a frontier market about 15 years ago. Its market capitalization grew from US\$18 billion as of the end of 1992 to US\$4.7 trillion as of the end of June, according to Standard and Poor's.

Amid jitters over a U.S. slowdown and its impact on global economies, frontier markets offer investors the opportunity to invest in a younger generation of emerging markets, and diversify their portfolios.

Many characteristics that make emerging markets fascinating are now evident in frontier markets:

Positive economic trends such as high growth

Qatar, United Arab Emirates and Panama are forecast to grow

11.8 percent, 8.4 percent and 7.0 percent respectively in 2008, compared to the much slower growth expected of the U.S. (1.5 percent), the U.K. (1.7 percent) and Japan (1.3 percent), figures released by the Economist Intelligence Unit as of the end of July showed.

High potential for capital market development

Bangladesh, Botswana, Estonia and Tunisia have a market capitalization of less than US\$10 billion, while larger frontier markets – Croatia, Romania and the Ukraine – have between US\$50 billion and US\$100 billion. These numbers pale in comparison to emerging markets such as China, India, Brazil and Russia, all of which have a market capitalization greater than US\$1 trillion. Brazil's market capitalization, for example, stood at just US\$45 billion 15 years ago, according to Standard and Poor's June figures.

Relatively low correlation to world markets due to their diversity

The correlation coefficient between the S&P Frontier Markets Index compared to the three major MSCI Indices – MSCI World, MSCI Europe and MSCI Emerging Markets – is only about 0.6 (see table below). The low correlation between frontier and global markets can help investors spread risks by not putting all their capital into the same basket.

Attractively valued companies

Many companies in the frontier markets are selling at very low prices, considering their exponential growth. For example, the Estonia, Kazakhstan, Latvia and Panama markets are all trading at a price-to-earnings ratio of less than eight times. In comparison, the U.S. and Japan are trading at price-earnings ratios of 17 and 16 times respectively, according to Standard & Poor's end of June figures.

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2-year correlation coefficient	MSCI World	MSCI Europe	MSCI Emerging Markets
S&P Frontier Markets	0.65	0.58	0.64

Source: Factset as of the end of June



Ukraine is one of the biggest frontier markets worth exploring.

Typically under-researched

Fewer investment brokers and asset management companies are researching and covering frontier markets, compared to those covering emerging markets. This gives early investors an added advantage.

Frontier markets have been outperforming developed and emerging markets because they haven't been dragged down by the recent turmoil in global financial markets or fears of a U.S. recession.

In the one-year period ended June, the S&P/IFCG Bangladesh, Cote d'Ivoire and Mauritius indices yielded returns of about 60 percent in U.S. dollar terms, while the S&P/IFCG Lebanon index gained more than

100 percent. Other markets such as Trinidad and Tobago, Tunisia, Kenya and the Slovak Republic all rose about 30 percent, compared to the MSCI World Index, which fell 10 percent in U.S. dollar terms, according to Standard & Poor's.

Despite the apparent attraction of frontier markets, the risks (such as poor information, illiquid stocks and sudden government policy changes) involved in investing in them remain high. Africa, for example, is rich in commodities and we expect to see much progress. But it is not for the faint-hearted as there will be setbacks along the way.

Though investing in frontier markets remains a challenge, it is already much

easier compared to investing in emerging markets many years ago. Portfolio managers usually manage the risks by leaving a healthy margin for error in the stocks they select for investment and avoiding a few countries where the economic and political outlooks are too difficult to predict.

Frontier markets are going to develop into emerging markets and investors should be prepared to take advantage of the frontier markets' growth.

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Disclaimer: The commentary sets forth our views as of the date published and there is no guarantee that any forecasts expressed will be realized.

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