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September 2010

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MARKETING INTELLIGENCE Report

Frontier Markets– An Overlooked Opportunity?

Introduction

Emerging market equities have experienced quite a ride since the 1990s. While the road has been rocky, with the Asian currency crisis being just one event, the eventual reward for long-term investors was significant. Today, emerging market equities have earned a place in many investors' portfolios. Frontier markets may be embarking on a similar journey, with the potential for long-term rewards for those who follow the less traveled path of this riskier asset class.

Certainly, frontier markets come with significant risks. Frequently the risks are known and priced into the securities and they are not necessarily different than the risks one sees in emerging and developed markets. In fact, many investors have enjoyed the benefits of exposure to emerging markets in recent years but view frontier markets as too risky. Avoiding frontier markets doesn't guarantee avoiding country specific or systemic risks in the developing world. Venezuela was part of the MSCI Emerging Markets Index when President Hugo Chavez decided to nationalize its main oil company. It is now a frontier market. When Russia shut down its stock exchange several times in the fall of 2008, it was part of the MSCI Emerging Markets Index. Russia remains an emerging market today.

Frontier markets offer the potential for strong long-term returns and diversification benefits at a reasonable level of volatility. There are caveats to those assertions and much to think about before investing. This paper serves as an introduction to frontier markets, discussing both the potential advantages and risks associated with this asset class.

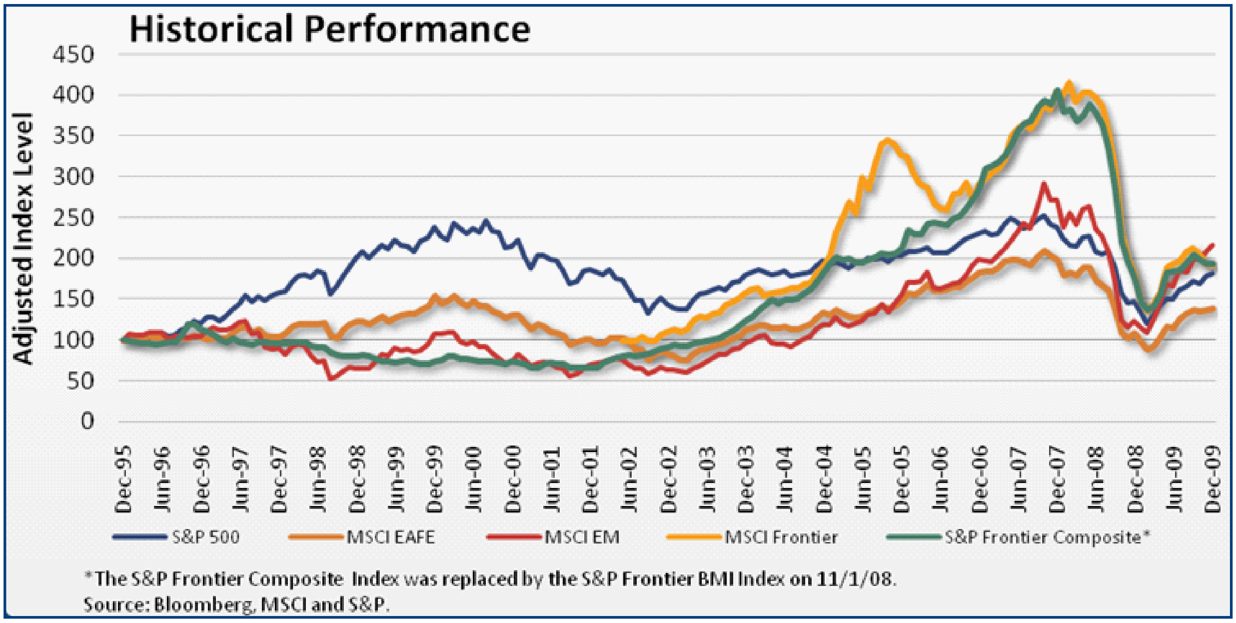
What are Frontier Markets?

There is no precise definition of frontier markets. Generally, they are considered to be low liquidity markets outside of developed markets (defined as the MSCI EAFE Index constituents and Canada) and emerging markets (defined as the MSCI Emerging Markets Index constituents). These "outsiders" encompass 70-80 stock markets that total approximately $233 billion in market cap[1], or 1% of the total world market capitalization[2].

Performance

The performance of frontier markets needs to be sufficiently enticing in order to make the inherent risks acceptable to investors. While data is only available back to 1995, the following graph reveals that frontier markets have fared better than the developed world and emerging markets over most time periods.

Until the end of 2007, frontier market returns were up in the stratosphere. The crash of 2008, however, brought them down to earth and closer to other asset classes. For investors looking to establish new positions in frontier markets, this crash is a positive development. The four frontier markets strategies in the eVestment Alliance database were, on average, in the bottom 99th percentile of emerging markets managers for the one-year period ending September 30, 2009.



This example is for illustrative purposes only, an investor cannot invest in an index.

Historical Valuations

Frontier markets have historically been less expensive than developed non-US markets based on price-to-earnings and price-to-book ratios, but more recently the trend has been towards convergence on valuation. Since 2000, frontier and emerging markets have had similar valuations, with the largest divergence occurring in 2009, as emerging markets rallied much more strongly than frontier markets. It is also worth noting that the more easily investable frontier markets have routinely had much higher valuations than the more exotic frontier markets.

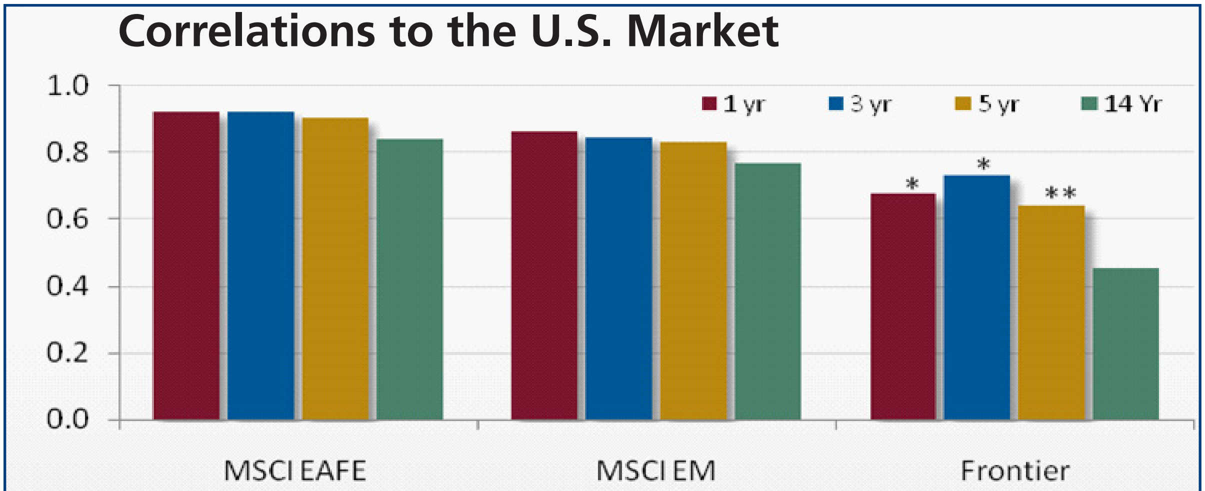
While most equity classes rebounded heavily in 2009, frontier markets remained largely overlooked. At the end of 2009, emerging markets were off only 26 percent from their 2007 peak. In sharp contrast, frontier markets were still down 53.7 percent. This could be a sign of opportunity for investors.

Potential Diversification Benefits

One attractive point about frontier markets is their low correlation relative to other equity asset groups. The following chart compares the correlations of frontier markets, emerging markets, and developed non-U.S. markets against the U.S. Market (Russell 3000 Index). The data shows that frontier markets have been less correlated to the U.S. Market than emerging and developed non-U.S. markets, particularly over a 14-year time period.

The more recent one- and three-year periods suggest that frontier markets are becoming more correlated to U.S. Markets. This is to be expected as frontier markets grow and evolve into more developed markets. However, this process should be slow and is unlikely to occur in such a dramatic shift as the charts suggests. The financial meltdown of 2008 and resulting breakdown of global financial markets increased short-term correlations across all equity asset classes. With nowhere to hide, frontier market correlations shifted dramatically with the rest of the financial market. Interestingly, if 2008 was excluded from the correlation calculations and the end date was December 31, 2007, frontier market correlations to the U.S. for a one-year and five-year trailing period would be 0.27 and 0.11, respectively, versus 0.66 and 0.69 for emerging markets and 0.71 and 0.81 for EAFE. When markets return to a more "normal" state, we would expect frontier markets to largely resume their historically low correlations.

Because frontier markets are small and relatively isolated from one another, especially compared to their more globalized counterparts in the emerging markets space, they exhibit low cross-correlations from country to country. This low cross-correlation can be utilized as an important tool for diversification and reducing overall portfolio volatility. Vietnam's inflation issue doesn't affect Sri Lanka and Sri Lanka's success over the Tamil Tigers military group didn't affect Vietnam.



*Based on average of: 1) S&P Frontier Composite 2) MSCI Frontier Index and 3) S&P Frontier Extended 150.
**Based on average of: 1) S&P Frontier Composite and 2) MSCI Frontier Index.
Note: S&P Frontier Composite Index was replaced by the S&P Frontier BMI Index on 11/1/08.
Source: Bloomberg, MSCI and S&P.

This example is for illustrative purposes only, an investor cannot invest in an index.

Volatility

Some investors may view frontier markets as a more volatile version of emerging markets. On a country- and stock-specific basis, this may be true, but a well diversified frontier markets portfolio may surprise some with its comparatively low volatility. Frontier markets in aggregate have historically been less volatile than emerging markets and comparable to EAFE.

Typically, the most volatile frontier regions are Eastern Europe and the Middle East. The less developed and less liquid a frontier market, the less volatile its returns tend to be. This is true in part because markets that trade less frequently have less price movement captured by volatility statistics; it does not necessarily mean they are less risky. Most frontier countries have lower volatility than the average emerging markets country. In the aggregate, frontier markets also have lower volatility than emerging markets.

Risk

Though frontier markets have many positive attributes, they do come with risk. In addition to the usual risks associated with international investing, frontier markets have risks that are specific to them or more severe, such as liquidity risk, country risk, and the risks of local market dynamics.

Liquidity Risk - Frontier markets' low liquidity levels can make entering and exiting positions challenging. Low trading volume requires large investors to be slow on the way in and slow on the way out. This requires timing a purchase correctly, or more importantly, not liquidating a position too quickly to avoid losing significant value on the way out.

A lack of liquidity is one reason that active managers differ considerably in their approaches to frontier markets. The active managers that focus on more liquid areas of the frontier markets can run much larger asset pools, but the managers who focus on the less liquid areas of the frontier markets have access to what is likely to be the better long-term investment. The superior opportunity set comes at the cost of higher transaction costs, lower liquidity and, often, higher management fees.

Country Risk - In most developed countries and the larger emerging countries, investors are usually concerned with the standard country risks, such as economic, political, and currency risk. Moving into the frontier markets, investors begin to give more consideration to issues like the stability of a country's government or the potential for war. Good results can morph into problems too. Rapid economic growth may lead a government to hurriedly enact policies to protect local currencies or businesses from inflation. Other types of risk include: corruption in business and politics, public health concerns, and limitations on economic and political freedom. In extreme cases, these problems can lead to an investment being wiped out over night. In other situations they could have little to no effect on an investment. It is important to recognize these risks and their potential repercussions to a portfolio.

Local Market Dynamics

Inexperienced Local Investors - Many frontier markets are still dominated by local investors who are inexperienced compared to their developed world counterparts. Local investors' unsophisticated approach tends to have a larger presence in frontier markets than in developed or emerging markets. From an investor standpoint, irrational market participants can lead to irrational market behavior, which leads to short-term headaches but long-term opportunities.

Transparency - Good information flow is frequently lacking in frontier markets. Language barriers, lack of timely financial reporting, and a lack of insightful research are added challenges to analysis. Although all of these characteristics add a risk premium for the unknown, this opacity can also be a source of alpha for an active manager who knows where to look, and what to look for, in the frontier markets space.

Conclusion

Frontier markets appear to be a very attractive segment in which to allocate risk capital. This is based on the attractive valuations relative to their long-term potential, diversification benefits due to low cross-country correlations, strong economic growth, and the potential for active management to add value. When an investor allocates to frontier markets, it is important to diversify across countries and regions to minimize idiosyncratic risk.

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[1] *Market cap of S&P Frontier BMI Index 12/31/2009*

[2] *Comparing S&P Frontier BMI Index to MSCI All Country World Index 12/31/2009*

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