FRONTIER MARKET
Asset Management, LLC
...the road less traveled

Frontier Markets – Asset Class or Curiosity?

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By Lawrence Speidell

"History never repeats…but it rhymes" – Mark Twain

There is an opportunity in global investing today that parallels the conditions existing twenty years ago. Over the past two decades, many observers have been surprised by the progress of globalization and by the impact it has had on economic prosperity worldwide, especially in emerging markets. In the mid-1980s, it was impossible to predict the fall of the Soviet Union and the new freedoms that resulted in Eastern Europe. Similarly, it was impossible to predict the statement by Deng Xiaoping that "it doesn't matter if the cat is black or white, so long as it catches mice". That remark made capitalism legitimate in Communist China and led to an economic revolution that has raised living standards for more than one billion people. Some have called China's progress the greatest movement of people out of poverty in the history of mankind.

We cannot know today what surprises lie in the decades ahead, but we believe that the genie of globalization will not be put back in the bottle. Countries around the world are moving towards a better understanding of the basics of rule-of-law and incentives that are necessary for economic success. As countries move along this path, the greatest rewards can come for those places that have the greatest improvements to make. Today many of these countries are considered "frontier markets" because they have not yet joined the global investment community, although many of them have already joined the global economic community.

Frontier Markets in the World

There are more than 100 stock markets around the world in places that range from the wealthiest developed countries to some of the poorest. Throughout history, investors have had a bias towards keeping their money at home, but over the past 30 years modern portfolio theory and numerous academic studies have shown the benefits of diversification abroad. Many U.S. investors first became aware or the potential of global opportunities in the 1970s, spurred on by the success of the Japanese stock market. By the mid-1980s, the investment world had expanded but was composed almost exclusively of the developed markets in North America, Europe and Japan. Beginning at that time, the International Finance Corporation, part of the World Bank, started to encourage interest in stock markets in the developing world by sponsoring the establishment of country funds to invest in markets in places like Malaysia, Thailand, Korea, and Brazil. In addition, Capital International Perspective (later part of Morgan Stanley) introduced emerging market indexes that served to further increase the visibility of stock markets in many less-developed countries. The term "emerging markets" provided a positive connotation that remains with them today; and now after 20 years of progress, it is hard to deny that many of the so-called emerging countries have in fact successfully emerged.

Today roughly 60 stock markets can be considered frontier markets because they are outside the normal universe of global investors. These frontier markets range from tiny Cote d'Ivoire with a $4 billion market capitalization to countries like Kuwait with $128 billion and Ukraine with $43 billion. They have a total market capitalization of almost $600 billion. Still, this is less than 1.5% of the total world market capitalization.

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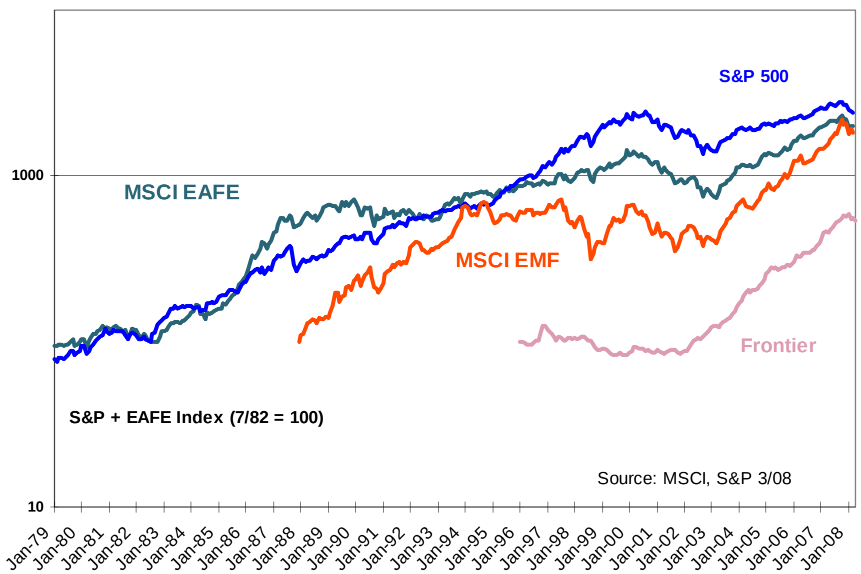
Table 1

	Mktcap 2006 World Bank ($mil)
Europe	$193,348
MidEast	$236,063
Africa	$91,236
Asia	$23,496
Latin Am	$37,530
	$581,673

Source: World Bank, 2006

Turning to financial performance, Standard & Poor's tracks 22 Frontier Markets in its S&P/IFC Frontier Markets Composite. The companies in this index had a total float of $63 billion as of March 2008, and they represent a significant portion of the capitalizations of their individual markets. Results have been good, with a total return for the Composite of 437% from December 1996 to March 2008, compared with 224% for the MSCI Emerging Market Index, 130% for MSCI EAFE and 164% for the S&P 500 Index.

Exhibit 1



Global Economies

Over the last 100 years radio, telephone, television and air transportation have downsized the world. Then 20 years ago, the fall of the iron and bamboo curtains brought two billion people with new sources of productivity into the global economy. Now we see that those events have also created two billion new consumers, placing heavy demands on global resources.

While world attention focuses on the BRICs and the other popular emerging markets, more than 1.2 billion people live in frontier market countries. Their incomes are generally low, with a 2005 median GDP per capita of $1,377 (excluding the Mid-East). On the other hand, these countries have had average annual GDP growth from 2000 to 2005 of 4.3% compared with 2.6% for EAFE countries, 2.8% for the U.S. and 4.4% for emerging market countries. Frontier markets had 15 out of the 20 fastest growing economies in terms of average annual GDP growth from 2000 through 2005. While investors are well aware of China's high growth, a 9.3% average, few know that Armenia and Kazakhstan grew faster:

11.2% and 10.2%, respectively. Among others showing excellent growth were Latvia, 8.1%, Ukraine, 7.4%, Vietnam, 7.4% and Tanzania, 6.6%.

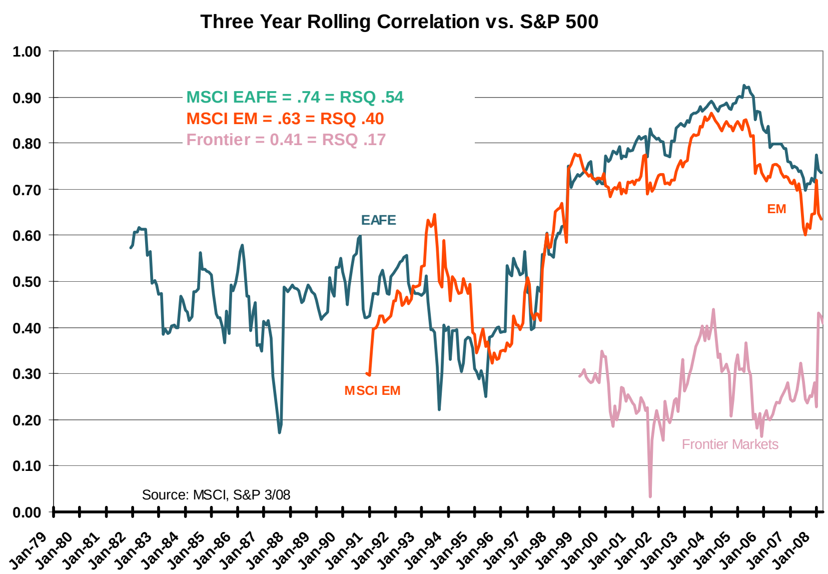
This strong growth is underpinned by the young population of most frontier countries at a time when the developed world is aging rapidly. Currently, only 14% of Japanese and Italians are under age 15, whereas in Zambia 46% are under age 15, in Tanzania 43% and in Bangladesh 36%. These young workers can produce goods for older consumers in developed countries, and as those young people become productive workers, they will also become significant consumers themselves.

Today, frontier markets are becoming discovered as sources of materials and labor, and they have several advantages that did not exist two decades ago for the emerging countries when they were at a similar stage of development. For example, cell phones now allow bypassing the decrepit state run land line phone systems that plagued emerging countries; personal computers and the internet provide access to knowledge that did not exist in the 1980s; and outsourcing of jobs is more accepted and established today. With world demand outstripping supply, there is much greater incentive to develop the human and materials resources in frontier regions today.

Risk and Diversification

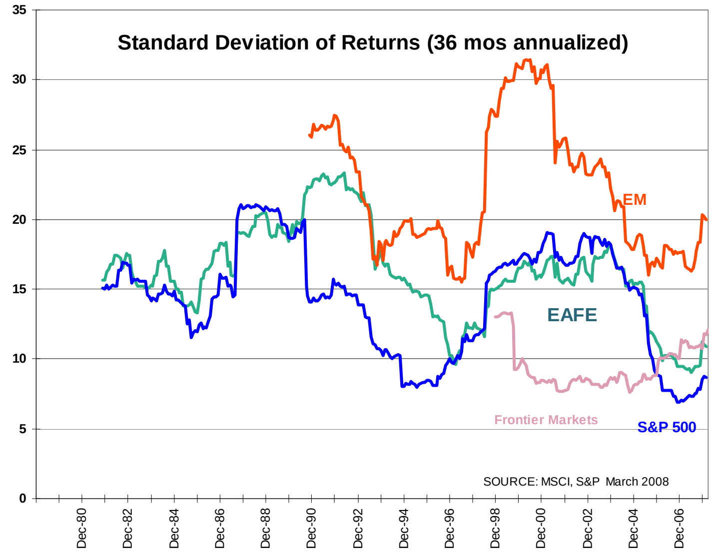
One of the challenges for investors in recent years has been the rising correlation among asset classes that has reduced diversification. The MSCI EAFE and Emerging Markets indexes had correlations of roughly 0.50 during the 1980s and early 1990s. These correlations when squared give an r-squared of 0.25, implying that 25% of the movement in the S&P 500 would be reflected in similar movement in these international indexes. Recently, however, these correlations have risen, to 0.74 for EAFE and 0.63 for emerging markets, giving r-squared of .54 and .40, implying that just over half of the movement in EAFE and 40% of the movement in emerging markets is tied to the S&P 500. On the other hand, Frontier markets remain quite local in character, driven by their own internal economic and political dynamics. As a result, they have low correlations with the established markets and offer excellent diversification potential. As shown below, the correlation of the S&P/IFC Frontier Markets Composite with the S&P 500 Index is very low, at 0.41 implying that only 17% of their movement is related to the S&P.

Exhibit 2



The volatility of frontier markets is also low overall. Admittedly, individual frontier markets can have high volatility: Romania, for example, has an annualized standard deviation of monthly returns of 32% over 36 months, and it is 31% for Bangladesh. However, the correlation among these markets is extremely low. Bangladesh has a negative average correlation of 0.03 with the other countries in the S&P/IFC Composite. For Botswana, the average correlation with other Frontier Countries is low at 0.18. Interestingly, it is 0.62 with neighboring Namibia, yet it is only -0.38 with nearby Kenya.

Exhibit 3



These low correlations result in a low overall volatility for the Composite of frontier markets as a whole despite high volatilities of individual markets within it, as shown in exhibit 3. The overall standard deviation of the S&P/IFC Frontier Composite is only 12.1% compared with 20.0% for the MSCI Emerging Market Index, 10.9% for MSCI EAFE and 8.7% for the S&P 500 Index.

Frontier countries do have volatile political and economic systems, but even here, the news is good. We believe that a good measure of the investment opportunities in frontier markets is offered by the Heritage Foundation through its ranking of Economic Freedom, www.heritage.org, which is a score that includes measures of business freedom, trade freedom, monetary policy, property rights and corruption.

Table 2

Economic Freedom Ranks - Heritage Foundation 2008

Hong Kong	90.3	Germany	71.2	Israel	66.1	**Kyrgyz Rep**	**61.1**	**Zambia**	**56.4**
Singapore	87.4	**Lithuania**	**70.8**	**Malta**	**66.0**	**Macedonia**	**61.1**	Brazil	55.9
Ireland	82.4	Sweden	70.4	France	65.4	**Namibia**	**61.0**	**Nigeria**	**55.5**
Australia	82.0	**Armenia**	**70.3**	**Costa Rica**	**64.8**	**Lebanon**	**60.9**	**Ecuador**	**55.4**
United States	80.6	**Trin. & Tobago**	**70.2**	**Panama**	**64.7**	Turkey	60.8	Argentina	55.1
New Zealand	80.2	Austria	70.0	Malaysia	64.5	**Slovenia**	**60.6**	**Cote d'Ivoire**	**54.9**
Canada	80.2	Spain	69.7	**Uganda.**	**64.4**	**Kazakhstan**	**60.5**	**Nepal**	**54.7**
Chile	79.8	**Georgia**	**69.2**	Portugal	64.3	**Paraguay**	**60.5**	**Croatia**	**54.6**
Switzerland	79.7	**El Salvador**	**69.2**	Thailand	63.5	Greece	60.1	India	54.2
United Kingdom	79.5	Norway	69.0	Peru	63.5	**Kenya**	**59.6**	Indonesia	53.9
Denmark	79.2	**Slovak Rep**	**68.7**	South Africa	63.2	Poland	59.5	**Bolivia**	**53.2**
Estonia	**77.8**	**Botswana**	**68.6**	Jordan	63.0	**Tunisia**	**59.3**	China	52.8
Netherlands	76.8	Czech Republic	68.5	**Bulgaria**	**62.9**	**Egypt**	**59.2**	**Uzbekistan**	**52.3**
Iceland	76.5	**Latvia**	**68.3**	**Saudi Arabia**	**62.8**	**Swaziland**	**58.9**	**Ukraine**	**51.1**
Luxembourg	75.2	**Kuwait**	**68.3**	**Mongolia**	**62.8**	**Moldova**	**58.4**	Russia	49.9
Finland	74.8	**Uruguay**	**68.1**	**UAE**	**62.8**	**Sri Lanka**	**58.3**	**Vietnam**	**49.8**
Japan	72.5	Korea, Rep.	67.9	Italy	62.5	Philippines	56.9	**Guyana**	**49.4**
Mauritius	**72.3**	**Oman**	**67.4**	**Qatar**	**62.2**	Pakistan	56.8	**Venezuela, RB**	**45.0**
Bahrain	**72.2**	Hungary	67.2	Colombia	61.9	**Ghana**	**56.7**	**Bangladesh**	**44.9**
Belgium	71.5	Mexico	66.4	**Romania**	**61.5**	**Tanzania**	**56.4**	**Iran**	**44.0**
Cyprus	**71.3**	**Jamaica**	**66.2**	**Fiji**	**61.5**	Morocco	56.4	**Zimbabwe**	**29.8**

In their 2008 rankings above, the frontier markets are underlined. One can see that Russia (49.9), China (52.8), India (54.2) and even Italy (62.5) have worse scores than many frontier countries, such as Uganda (64.4), Panama (64.7) and Kuwait (68.3). Furthermore, the average of all frontier countries is 73.0 versus 75.3 for emerging countries, 83.2 for EAFE and 83.7 for the United States. Since 1995, the average of frontier countries has improved by 18 points, emerging countries by 13 points and EAFE by one point, while the US is flat. Investors who are already investing in emerging markets should not be overly concerned about the macro issues of investing in frontier markets.

Another important concern for investors is liquidity. Someone said that we are "buying today's prices and tomorrow's liquidity", but this understates the depth of the current trading environment in frontier markets. We have estimated the total trading volume of a sample of the largest 270 frontier market stocks in 35 countries.

Table 3

	Mcap (mil)	Avg Daily Volume $mil	Turnover	Stocks with trading volume data	Stocks Trading > $100,000 / Day	Stocks Trading > $200,000 / Day
Africa	$41,766	$19	9%	66	29	16
Asia	$31,948	$60	38%	61	44	34
E Europe	$103,380	$31	6%	92	55	42
Latin America	$11,071	$19	35%	16	4	2
Middle East	$184,597	$405	44%	34	33	33
Total (35 countries, 270 stocks)	$372,762	$534	29%	269	165	127

Source: Bloomberg

This sample of stocks has a total market capitalization of $373 billion and average daily volume of $534 million, representing 29% annual turnover. As shown by the regional breakdown, the Middle East represents the lion's share of this activity, but other regions still represent more than $120 million in daily trading volume. Overall, there are 127 stocks that trade more than $200,000 per day (excluding Bangladesh and Kuwait where we were unable to collect volume data). A portfolio holding 10 days volume of each of those stocks would have over $5 billion invested. Even a portfolio that equal-weighted those names, holding $2 million in each stock, would total of $254 million.

Structural Risks

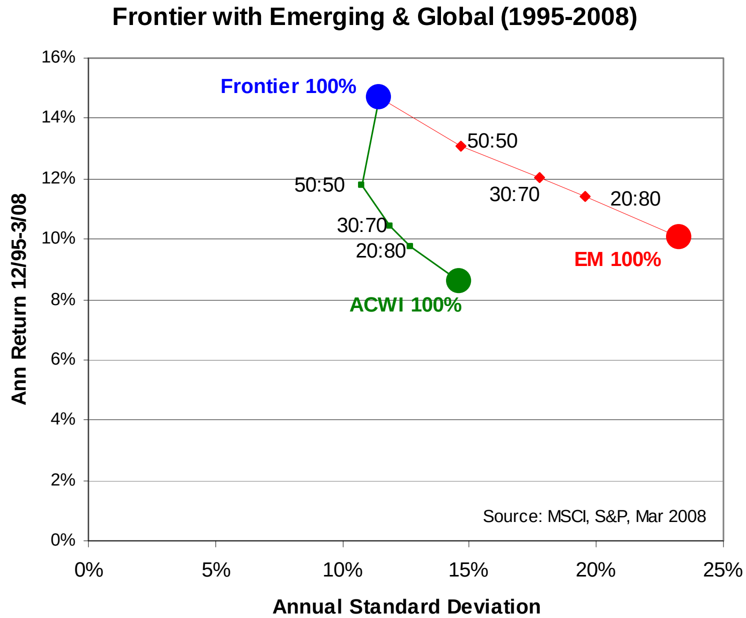
While the financial statistics of frontier markets are attractive, they do mask many challenges at the implementation level. Some of these are macro. The particular problems of individual countries can seem overwhelming, such as the military government in Bangladesh, the risk of reigniting civil war in Cote d'Ivoire, the bullying of Lithuania and Ukraine by Russia, the AIDS problem in Swaziland and the economic ruin brought on by Mugabe in Zimbabwe. While careful analysis can help avoid the worst of these problems, it is often out of problems such as these that the best opportunities arise. We believe the proper response is to search for the best stocks and diversify the country risks.

Next are the challenges of security analysis. Simply getting annual reports can be an ordeal. Furthermore, they are sometimes published more than six months after year-end. Once published, it may take more than a year before posting on the company website (if there is one). Furthermore, the reports are often short, lacking candid comments about the business outlook. While conference calls can be useful, phone service is intermittent, phone quality is low and language barriers can exist even when both parties believe they are speaking English. Local visits aren't easy either, given the challenges of local infrastructure and logistics. Obtaining research reports is similarly difficult, and their quality varies widely. Although there are more than 1000 analysts in frontier countries who have earned the right to use the Chartered Financial Analyst designation, reports on local companies are too often brief and factual rather than insightful. Financial forecasts are generally lacking. Ask a local broker about his or her market, and the first stocks you will hear about are the biggest, because they'd like you to make a large trade. Ask about their favorite stocks, and you'll hear about the three stocks that went up the most in the past month or year. Ask again and you may hear about an obscure name that's cheap but only traded twice in the past year. It takes effort and digging to find attractive buy candidates… Then there are market access issues, such as the bureaucracy of opening local accounts in the face of Byzantine regulations or local limits on foreign purchases. Until recently there was only one stock in Tanzania with less than the 60% foreign ownership limit. Order handling presents challenges too, with close monitoring needed to prevent orders from being "lost", executed in the wrong stock or settled with unexpectedly large currency conversion charges. Also, initial public offerings generally favor local investors, and often exclude foreigners altogether. Finally, commissions and fees can boost transaction costs to 3-5% each way.

Global Portfolios

Despite the challenges, we believe frontier markets are worth the work. In the chart below, we calculate the results of global and emerging markets portfolios with varying portions of frontier markets over the period from the end of 1995 to March of 2008, based on the index returns. While this is a simplistic study, it nevertheless indicates the attractiveness of blending frontier markets with more traditional portfolios.

Exhibit 4



Conclusion

While many investors still perceive frontier markets as being in decline, ravaged by wars, disease, famine and authoritarian governments, this view often reflects media reporting rather than reality. Many frontier countries have undergone a radical restructuring of their economies since the early 1990's, and their macroeconomic fundamentals are often sound and encouraging. Often real per capita GDP is rising, inflation is low, currency exchange rates are becoming more stable, and corporate profits and return on investment are relatively high. Thus, from an economic standpoint frontier market countries are indeed emerging rather than stagnating. They are not formally recognized as emerging today, but with further progress it will not be possible to ignore them much longer.

Looking ahead, these markets may represent the final frontier for global capital. As the emerging markets of today move on to become part of the developed world, the stage is set to bring along a new set of emerging candidates in the frontier markets. While available information is often sparse, local regulations are varied and complex and research coverage by analysts and brokerage firms is limited, these were also the characteristics of emerging markets twenty years ago. Challenges such as these create opportunities for investors to uncover neglected companies with healthy or improving operations and to identify stocks that have been ignored by the mainstream investment community. With patience and care, frontier markets can prove very rewarding, and can make a significant contribution to global portfolios. While they represent less than 1.5% of world market capitalization, they provide valuable diversification for global portfolios that are willing to go there first. If all global portfolios chose to do so, this inflow would reduce the diversification benefit, but it is very likely that the pioneers would be very pleased with their resulting performance.

About Frontier Market Asset Management

Founded in 2006, Frontier Market Asset Management holds more than 35 years worth of investment experience including work in Emerging and Frontier Markets since 1987. For more information, please contact us at (858) 456-1440.

This is not an offering. An offering will be made only by means of a final offering memorandum and only in those jurisdictions where permitted by law. The fund is subject to a variety of risks, including but not limited to: investments may be volatile depending on the type of hedging techniques employed and subject to stock market risk; investments may be illiquid; an investor could lose all or a substantial amount of any investment in the fund; there is no secondary market for interests in the fund nor is one expected to develop, and there are substantial restrictions on transferring an investment in the fund; fees and expenses of the fund may be higher than those of other investments and will reduce the portfolio return. Consult the fund's offering memorandum for complete risk disclosures and other important information.

The information has been compiled from sources we believe to be reliable, but we do not hold ourselves responsible for its correctness. Opinions are presented without guarantee.

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