



Diversification Snapshot: Frontier Markets in a Troubled World

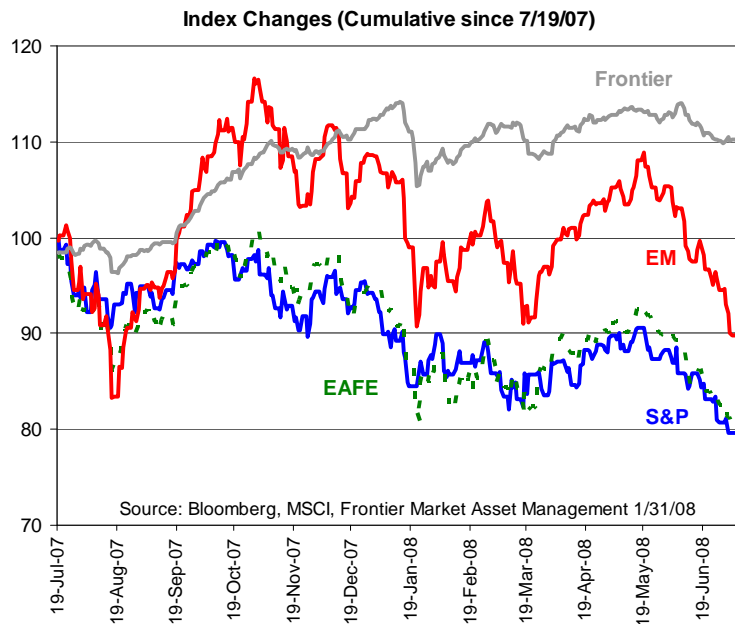
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During these challenging conditions in world financial markets, diversification is increasingly sought, yet it is often hard to find. Anxious to reduce risk, many investors sell whatever they can to raise cash, putting pressure on assets that otherwise may have good fundamentals. In this study, we examine the behavior of frontier markets over the past year. It has been suggested that decoupling may be occurring between the developed world and the emerging/frontier world, based on emergence of a middle class in many countries and increases in the level of trade across borders within the emerging/frontier universe. Thus far, it appears that there has been some degree of decoupling, although conditions could change given the possibility that the world's economic headwinds may be prolonged.

It has been almost a year since the Dow Jones Industrial Average peaked at 14,000 on July 19, 2007, but it seems like a distant age. Housing prices are down, the dollar is down, oil is up and the DJIA closed at 11,026 on Friday, July 11, 2008, for a decline of 21.2%. Meanwhile, the S&P 500 is down 20.6% and the MSCI EAFE Index (Europe, Australia and Far East) has dropped 19.5% in dollar terms. The MSCI Emerging Markets Index has been quite volatile, but is down only 8.8%. Our average of 28 Frontier Stock Markets has fared better with a gain of 12.1%.

Exhibit 1



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Other changes, shown in exhibit 2, have been dramatic. The dollar has weakened 15% versus the Euro, oil is up 91%, gold is up 42%, copper is up 4.5%, T-bill rates are down from 4.98% to 1.60%, the 10 year Treasury Bond is down from 5.02% to 3.92%.

Exhibit 2

	Oil Brent Futures	Gold	Copper	Euro	3 mo T- Bill	10 Yr Gov
7/19/2007	74.9	677.5	7920.0	1.38	4.98	5.02
7/11/2008	143.5	962.1	8279.0	1.59	1.60	3.92
Chg 7/19-7/11	91.5%	42.0%	4.5%	15.1%	-67.8%	-22.0%

Source: Bloomberg, Frontier Market Asset Management, July 2008

The big surprise has been that general commodity prices have held up and oil has surged, despite the troubled economy in the U.S. and softness in the rest of the developed world. Emerging and frontier market economies continue to grow and this has put pressure on resources, reminiscent of the early 1970s, when the Club of Rome predicted shortages described in the broadly quoted book, Limits to Growth (1972).

Looking at the frontier markets in more detail, exhibit 3 examines the behavior of our sample of 28 frontier markets on a regional basis over the past year. There are significant differences, with Eastern Europe being the only frontier region that is down. This results from its close economic ties to the rest of Europe, and from the fact that European investors have invested heavily in Eastern Europe markets in general without distinguishing between those in the MSCI Emerging Market Index (Poland, Hungary, Czech Republic and Russia) and the rest. This has led to higher valuations and higher correlations relative to Europe. At the other extreme is the Middle Eastern frontier markets, which have been strong on the back of higher oil prices and the resulting inflows of capital.

Exhibit 3

	Frontier Markets Ave (28)	Frontier Asia (3)	Frontier Africa (4)	Frontier Europe (9)	Frontier Mid- East (12)
% Change 7/19/07-7/11/08	12.1%	8.4%	28.2%	-17.8%	38.9%

Source: Bloomberg, Frontier Market Asset Management, July 2008

The charts below show recent performance during the sharp declines in the month of January. Frontier markets have continued to provide diversification and better resistance on the downside than the rest of the world. The Middle Eastern markets have performed the best, followed by Africa, while Eastern Europe has been the weakest.

Another measure of the behavior of frontier markets is the correlation of daily returns versus the S&P 500 Index. In exhibit 4, we have calculated correlation for each index or group over the past year).

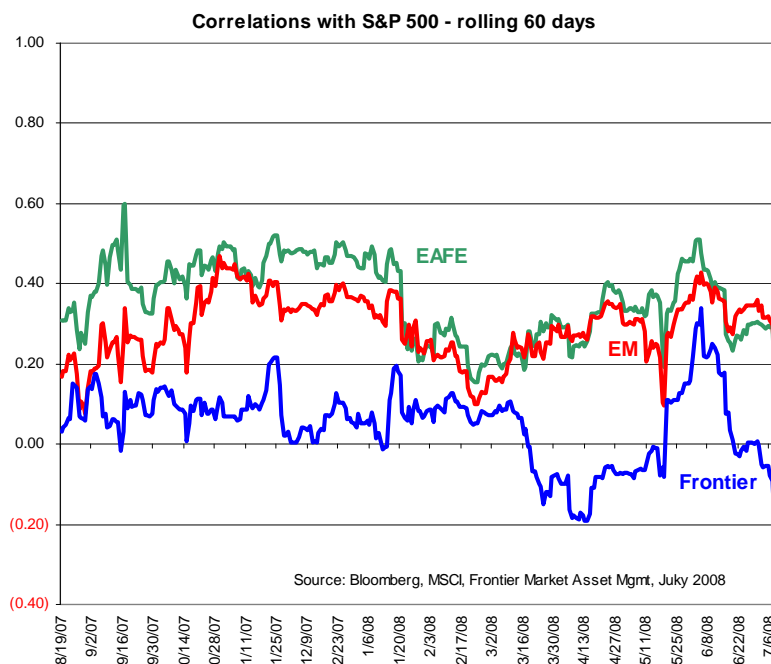
Exhibit 4

Daily Correlation 7/20/07 to 7/11/2008	S&P 500	DJIA	R2000	EAFE	Emerging Mkts	Frontier Market Average (28)	Frontier Asia (2)	Frontier Africa (4)	Frontier Europe (9)	Frontier Mid-East (11)
	1.00	0.98	0.93	0.31	0.27	0.03	(0.05)	(0.16)	0.02	0.03

Source: Bloomberg, Frontier Market Asset Management, July 2008

Although these correlations are over a short period, they show the same low correlations for frontier markets that we have observed over longer periods of three years or more. Rolling 60 day correlations produce a perspective, shown in exhibit 5.

Exhibit 5



The correlation of frontier markets with the S&P has been consistently lower than those of EAFE and Emerging Markets, although recently all correlations have jumped around quite a bit. (Note also that these correlations on a rolling 60 day basis are lower than the more traditional monthly correlation results. We believe this is because data include noise that washes out when using monthly observations.)

For a final perspective on correlations, we show below the correlations of the frontier regions versus EAFE over the year. Here there is a close relationship between the European frontier with the rest of Europe, while frontier Africa and frontier Asia have very little linkage to Europe.

Exhibit 6

Correlations versus EAFE: 7/07-7/08	Frontier Market Average (28)	Frontier Asia (2)	Frontier Africa (4)	Frontier Europe (9)	Frontier Mid-East (11)
	0.63	0.04	0.08	0.69	0.17

Source: Bloomberg, Frontier Market Asset Management, July 2008

For another perspective on the world, we show the correlations of daily price movements for the indexes and regions versus commodities in exhibit 7.

Exhibit 7

Daily Correlations with Commodities from 7/20/07 to 7/11/08

	S&P 500	EAFE	Emerging Mkts	Frontier Market Average	Frontier Asia (2)	Frontier Africa (4)	Frontier Europe (9)	Frontier Mid-East (11)
Copper	(0.01)	0.36	0.46	0.32	0.05	0.03	0.35	0.14
Gold	(0.00)	0.28	0.20	0.29	(0.04)	0.04	0.37	0.06
Oil	(0.06)	(0.09)	(0.08)	0.22	0.21	0.29	0.01	0.03

Source: Bloomberg, Frontier Market Asset Management, July 2008

As investors know only too well, the S&P has gone down as oil has gone up. It is surprising that within the frontier, Asia and Africa have had higher positive correlations with oil than the Middle East. Looking at gold and copper, it is interesting that EAFE and frontier Europe have had relatively high correlations. Across the frontier market universe, however, there is a broad mix of country exposures, with some being oil exporters (Nigeria) others rich in copper and gold (Zambia and Botswana), while others are resource poor (Bangladesh and Vietnam). What they all share is high percentages of their CPI market-baskets taken up by food and fuel. With slower world growth, we are hopeful that these pressures on frontier country inflation rates will abate.

Conclusion

These results offer evidence that frontier markets continue to provide useful diversification benefits. Local investors tend to dominate trading in these countries, and they are much more concerned with local economics and local politics than with sub-prime loan problems in the U.S. While, foreign investors are starting to arrive in frontier markets, so far they have exhibited a prudent a long term investment horizon rather than a trading mentality. Hopefully, these patterns will continue to make frontier markets rewarding as the world works through its current global economic challenges.

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.

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