Thoughts on Frontier Stock Markets
By Lawrence Speidell and Axel Krohne, 2007

Over the past year, we have spoken with several hundred investors regarding Frontier Markets. We have discussed the pros and cons of Frontier Markets from many angles. During more than two decades of investing in emerging and frontier markets, we have cleared customs hundreds of times, and we have looked at thousands of company reports and research reports. We have questioned our beliefs and tested them. Based on all of this, we have developed the conviction that Frontier Markets offer a bright future to investors.

We believe, however, that our positive view of Frontier Stock Markets rests on four elements that are open to discussion and to differing opinions. These elements are history, globalization, risk and optimism. If everyone agreed with us on these points, Frontier Markets would be much more exploited, much more expensive and much less attractive than they are today.

We believe our positions are reasonable, but we recognize that others will differ. Here is what we believe:

History: Frontier markets will follow the path that “Emerging Markets” have taken over the past twenty years

In the past two decades, we have seen wonderful progress in the countries that have been part of the Capital International Perspective (now Morgan Stanley Capital International, or MSCI) Emerging Markets Index since 1987. The governments of South Korea and Taiwan have progressed towards strong democracies, China has embraced capitalism, Eastern Europe has also embraced capitalism… and Starbucks has arrived in Shanghai. In fact, it can be said that over the last twenty years, China has experienced the greatest movement of people out of poverty in the history of mankind. Meanwhile, emerging stock markets have delivered strong performance (despite suffering banking and currency crises in the 1990s). Looking at Frontier Markets, we believe they will follow this path, because it is easier to follow than to lead. The examples have been set, and the principles of rule of law and incentives are understood. Vietnam is now copying China in bending its harsh dogmas, Romania and Bulgaria are now joining and learning from the EU. And many African countries are seeing the example set by South Africa. As Mark Twain is reported to have said, “History doesn’t repeat, but it rhymes”. We believe this will describe the path of frontier countries and their stock markets in the years ahead.

Globalization: The world is shrinking

100 years ago radio, telephones and air transportation downsized the world. Then came television, jet planes and, recently, mobile phones and the internet. Several years ago, we learned that Baywatch was one of the most popular TV programs in Borneo. Now Sesame Street is shown in 140 countries. Because of television, the “have-nots” in the world have learned what the “haves” have, and most of them are motivated to work hard to get it. At the same time, the search for lower costs has led to outsourcing and specialization in production, providing jobs in places that never had such opportunities before. While many decry poor working conditions and environmental damage in some developing countries, progress is being made and living conditions are improving. GaveKal research has estimated that productivity rises ten-fold when workers move from farms to industry. Much of this productivity returns to those workers in the form of higher incomes and even better opportunities for their children. In countries such as China and India, a rising middle class is generating its own demand. McKinsey estimates that there will be 300 million middle class households in China alone in twenty years. Much of this progress depends in education, and this is a critical area that will separate countries in the
years ahead. China already produces more graduates with Bachelors and Associates degrees than the U.S. This progress is not evenly distributed: too often in Latin America access to higher education is still decided on a class basis. Despite educational disadvantages, however, the internet has proven to be an effective leveler in the field of knowledge, making information available in schools and homes in even the poorest and most remote places.

**Risk: We cannot choose risk… we must diversify it**

Frontier countries are indeed risky. They have volatile political and economic systems. Corruption often overwhelms rule of law. Their health care environments are primitive. Their financial markets are still developing in terms of transparency and liquidity. Yet when we read the news of political and corporate scandals our own country, we realize that no country is perfect. Human nature is much the same everywhere, and all countries share the problems of frontier markets to some degree. What is important is the trend in these risks. Surveys of economic freedom such as those by the Heritage Foundation and the Frazer Institute show that frontier countries in general are moving in the correct direction. For some, it may be two steps forward and one step back, but still the trend is favorable. A sage once said: "The years know more than the minutes." To see this, we must step back from the day-to-day current events and take a perspective that reveals the long-term opportunities.

Another feature of frontier market risks is that they are extremely diversified, both among one another and relative to the other risks we face. Professor Howard Stevenson of Harvard Business School has pointed out that risks that are different from the risks we already have can be very valuable to us. We all face risks, and they cannot be avoided. However, risks that are different reduce our overall risk, by behaving in different ways at different times. In the case of Frontier Stock Markets, the correlation among the 22 countries in S&P/IFC Frontier Market Composite is low, so that the overall Composite has a standard deviation of only 12% on an annualized basis. This is similar to that of the EAFE Index of developed countries, even though some individual Frontier Markets have standard deviations as high as 40%. Looking at diversification versus other markets, the correlation of the Frontier Composite with the S&P 500 is only 0.35, whereas the correlation of the MSCI Emerging Markets Index with the S&P has now risen to over 0.70.

**Optimism: The world is becoming a better place**

There are many troubles in the world today, including nuclear proliferation, terrorism, religious fundamentalism, diseases like AIDS and bird flu and global warming. Because of these troubles, many people hesitate to invest for the long term. And yet problems will always be with us. Nick Murray, in Financial Advisor, October 2006, calls this the “tyranny of current events”. He points out that the Dow Jones Industrial Average has gone from 200 to 12,000 while we have endured World War II, the Korean War, the Cuban Missile Crisis, the Cold War (and its Mutual Assured Destruction), Vietnam, the assassinations of President Kennedy and Martin Luther King, the financial meltdown of October 1987, September 11th, 2001, the scandals of Enron and Worldcom, the technology stock bubble and more. These events, and the fears of more like them, have prevented many investors from benefiting from the growth of the world economy and its financial markets. While the progress of mankind has been irregular, it has been positive. Certainly the next twenty years will bring their share of headline disasters, yet we believe that progress will continue. And we believe financial markets will be continue to move higher.

**Conclusion**

The case for frontier equity markets rests on the four pillars of history, globalization, diversification and optimism. If the world is becoming a better place, then conditions in frontier countries will continue to improve. We believe this improvement will be gradual rather than dramatic, measured by years and decades. Over time, it will lead both to better living conditions and to rewarding investment opportunities. This optimism does not require us to believe that the United States, Europe or Japan will necessarily continue to lead the world. In fact by demographic measures, the trends in most developed countries are quite unfavorable. But frontier countries have strong demographics, with young people becoming more productive each day. And economically, they are so far behind that the catch-up process can run for decades. Nor does being an optimist about frontier countries depend on a prediction of global religious and cultural harmony. There will always be people who are resistant
to change, to modernization and to harmonization. In fact, looking back at the history of emerging countries, we see that they followed many divergent paths with varying degrees of success. Despite this, there has been great progress overall. We believe the same pattern will occur in frontier countries. We can not predict which countries will succeed or which will fail (much like the difficulty of predicting venture capital investments), but we believe that the typical frontier country will do quite well. Much of this will be due to globalization, where the full impact of changes already in place is yet to be appreciated. Rising trade and outsourcing along with improved communications and education will have positive effect on many coming generations. As for risks, the frontier markets today are much like emerging markets twenty years ago. With time, risks will diminish; but meanwhile, diversification benefits are high and prices are low.

REFERENCES


Stevenson, Howard H., Make Your Own Luck, Penguin Group, 2005