



Frontier Benchmarking: Too Much of a Good Thing... or Not Enough?

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“Too much of a good thing can be wonderful” – Mae West

A year ago, there was no good definition of a Frontier Market. The term was coined by the International Finance Corporation, part of the World Bank, and they created an informal composite of 21 countries which was later taken over by S&P as the S&P/IFC Frontier Markets Composite. Then in July 2007, S&P introduced the S&P/IFC Extended Frontier 150 (150 of the largest and most liquid companies from a pool of 30 Frontier Markets), and they followed that with the S&P Select Frontier Index (a subset of the Frontier 150 that has 30 companies from 11 countries). Most recently, on December 17, 2007, Morgan Stanley Capital International has introduced the MSCI Frontier Markets Index, covering 19 countries.

While we are delighted to see these indexes arrive because they focus more attention on this growing sector of the financial world, we are concerned that they may cause confusion and may limit the potential universe for global investors.

What’s In, and What’s Out

Table 1 shows the exposure of the three of the benchmarks to five global regions. We have also included the percentages of market capitalizations from the most recent (2005) data in the World Bank’s WDI database.

Table 1 – Index Comparison

	World Bank Mktcap 2005	S&P/IFC Frontier Composite	S&P/IFC Frontier 150	MSCI Frontier Markets
Africa	7.3%	20.2%	14.3%	14.5%
Asia	2.7%	11.5%	7.7%	6.5%
Europe	15.9%	48.6%	11.8%	12.4%
Latin Am	9.2%	11.5%	11.3%	0.0%
MidEast	64.8%	8.2%	54.8%	66.6%
	100.0%	100.0%	100.0%	100.0%
Countries	69	22	26	19

Upon review, what stands out is that the indexes are a small sub-set of the countries that we consider to make up the Frontier Markets. Out of 69 countries that have market capitalizations in the World Bank

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database almost half, thirty-three, are excluded from the three indexes. Saudi Arabia is presently closed to foreign investors, but most of the others are open. Another problem is that the indexes are dominated by regions rather than diversified across them. Two thirds of the new MSCI Frontier Market Index is in the oil-driven Middle East, as is 55% of the S&P/IFC Frontier 150. Meanwhile, almost half of the older S&P/IFC Frontier Market Composite is in Eastern Europe.

When we look at Frontier Markets, we see five regions: Africa, Eastern Europe, Asia, Latin America and the Middle East, each with unique opportunities and challenges that can provide excellent diversification benefits across regions. Africa may, at last, be awakening and joining the world of commerce thanks to demand for its commodities, improved politics and economics, and investment from abroad, especially China. Eastern European Frontier markets are benefiting from closer ties to Europe as well as the progress of their emerging country neighbors, Russia, Poland, Hungary and the Czech Republic. Asian Frontier markets are copying China and India, while Latin American Frontier Markets such as Costa Rica, Trinidad and Tobago and Jamaica are improving their economic policies and benefiting from the progress of their neighbors. Finally, the countries in the Middle East are being recognized not just as sources of recycled petrodollars, but as investment destinations in their own right.

Turning to country level analysis, Table 2 summarizes the countries in the MSCI Index, all of which are in at least one of the S&P Indexes.

Table 2 – Markets in both the MSCI and S&P Frontier Markets Indexes

		Population (million)	GDP per capita (2005)	Market Cap World Bank (latest) \$ Mil	World Bank %	MSCI Frontier Markets Index	S&P/IFC Frontier Composite	S&P/IFC Frontier 150
MidEast	UAE	4.5	\$22,975	\$138,531	11.0%	21.0%		11.87%
MidEast	Kuwait	2.5	\$20,578	\$128,940	10.2%	32.2%		15.00%
MidEast	Qatar	0.8	\$36,000	\$61,563	4.9%	7.9%		9.38%
Europe	Ukraine	47.1	\$960	\$42,870	3.4%	0.9%	7.0%	0.72%
Africa	Nigeria	131.5	\$459	\$32,819	2.6%	12.1%		12.00%
Europe	Romania	21.6	\$2,259	\$32,784	2.6%	1.7%	11.0%	4.02%
Europe	Croatia	4.4	\$5,211	\$29,006	2.3%	3.7%	6.1%	1.28%
MidEast	Bahrain	0.7	\$14,588	\$21,122	1.7%	1.4%		1.83%
MidEast	Oman	2.6	\$8,961	\$16,158	1.3%	2.3%		2.52%
Europe	Slovenia	2.0	\$11,432	\$15,182	1.2%	4.9%	17.0%	3.89%
Africa	Kenya	34.3	\$442	\$11,378	0.9%	1.1%	4.8%	1.42%
Asia	Kazakhstan	15.1	\$1,978	\$10,521	0.8%	4.7%		5.82%
Europe	Bulgaria	7.7	\$2,071	\$10,325	0.8%	0.6%	2.6%	0.52%
MidEast	Lebanon	3.6	\$5,672	\$8,279	0.7%	1.7%	8.2%	1.94%
Asia	Sri Lanka	19.6	\$1,002	\$7,769	0.6%	0.4%		0.29%
Asia	Vietnam	83.0	\$538	\$6,046	0.5%	1.5%	9.0%	1.47%
Europe	Estonia	1.3	\$5,862	\$5,963	0.5%	0.6%	1.9%	0.55%
Africa	Tunisia	10.0	\$2,412	\$4,446	0.4%	0.3%	2.6%	0.05%
Africa	Mauritius	1.2	\$4,403	\$3,598	0.3%	0.9%	4.0%	
		393.8			46.7%	100.0%	74.2%	74.6%

These nineteen countries are “frontier” in the definitions of both index providers. However, it is interesting that five of them - United Arab Emirates, Kuwait, Qatar, Bahrain and Slovenia - are high income countries (GDP/capita over \$11,115), and thus are too rich to qualify as “emerging” countries in the original sense of the term that was coined by the World Bank. We think of them as “frontier” because they are outside the normal investment universe of developed and emerging markets, but they are certainly different from Kenya or Vietnam. Furthermore, it is hard to imagine wanting to use a normal portfolio weight of 32.2% in Kuwait, as it is in the MSCI FM Index. While Kuwait is a wonderful and fascinating country, its market is hardly the caliber of the financial centers in Dubai or Abu Dhabi (in the UAE). Another question about MSCI’s choices concerns Venezuela, which was dropped from MSCI’s Emerging Markets Index in 2006, but is not included in this frontier list. While Venezuela’s politics are not appealing to investors today, this will change over time.

In Table 3, we turn to the 17 countries recognized in either of the two S&P/IFC Indexes, but not in the MSCI Index.

Table 3 – Markets unique to the S&P/IFC Indexes

		Population (million)	GDP per capita (2005)	Market Cap World Bank (latest) \$ Mil	World Bank %	MSCI Frontier Markets Index	S&P/IFC Frontier Composite	S&P/IFC Frontier 150
Latin Am	Colombia	45.6	\$2,174	\$56,204	4.5%	Emerging		10.28%
MidEast	Pakistan	155.8	\$596	\$45,518	3.6%	Emerging		6.62%
MidEast	Jordan	5.4	\$2,086	\$29,729	2.4%	Emerging		5.62%
Latin Am	Trin. & Tobago	1.3	\$9,083	\$15,571	1.2%		6.5%	
Latin Am	Jamaica	2.7	\$3,291	\$12,277	1.0%		2.9%	
Europe	Lithuania	3.4	\$4,846	\$10,191	0.8%		2.2%	0.41%
Europe	Slovak Rep	5.4	\$4,762	\$5,574	0.4%		0.5%	
Latin Am	Panama	3.2	\$4,408	\$5,074	0.4%			1.04%
Africa	Cote d'Ivoire	18.2	\$577	\$4,155	0.3%		5.1%	0.87%
Latin Am	Ecuador	13.2	\$1,549	\$4,040	0.3%		2.0%	
Africa	Botswana	1.8	\$4,649	\$3,947	0.3%		2.7%	
Asia	Bangladesh	141.8	\$433	\$3,610	0.3%		2.5%	
Europe	Latvia	2.3	\$5,029	\$2,705	0.2%		0.4%	
Africa	Ghana	22.1	\$287	\$1,729	0.1%		0.7%	
Africa	Namibia	2.0	\$2,083	\$542	0.0%		0.3%	
Europe	Georgia	4.5	\$971	\$355	0.0%			0.45%
Asia	Cambodia	14.1	\$402	\$0	0.0%			0.16%
		442.7			16.0%	0.0%	25.8%	25.5%

Three of these countries - Colombia, Pakistan and Jordan - are included in the MSCI Emerging Markets Index, and thus they are already part of the universe for institutions that use the MSCI framework. We have accepted that distinction ourselves, and our firm’s definition of Frontier Markets includes all countries with stock markets that are not incorporated in the MSCI developed or emerging country indexes.

Excluding these three, there remain fourteen countries that have 236 million inhabitants and account for more than 25% of the S&P/IFC Frontier Composite. While Georgia may not be on everyone’s radar screen, others such as Trinidad & Tobago, Jamaica, Botswana, Bangladesh and Ghana are worthy of

attention. Latvia and Lithuania would seem to be potential additions to the MSCI list, since it already includes Estonia.

Finally, Table Four (4) summarizes the remaining frontier countries, ignored by all of the indexes. Of the three largest, Iran is forbidden for U.S. investors, Saudi Arabia is closed to foreigners and Iceland is a rich country that simply falls between the cracks of most developed country indexes. Next is Zimbabwe, a troubled state where inflation reportedly exceeded 100,000% in 2007. The stock market there has been a hedge against inflation for locals, but it is hard to get money in or out. Venezuela is fifth in size on this list, but the political problems mentioned earlier may keep investors away for some time.

The remaining 28 countries include many that represent what, we believe, frontier market investing is all about. They are countries that have stock markets with the potential to grow based on improved economic policies. Sometimes their political environments lean towards autocratic, as in Uzbekistan and Uganda, but this is little different from conditions in Kazakhstan, Egypt or Russia. Many of these countries are hard to get to, and when traveling in Africa most flights require a change of planes in Johannesburg or Nairobi. Also, investing is often difficult, requiring multiple registration forms and lengthy delays. For example, in order to have documents registered in Uzbekistan, they first must be notarized in the U.S. - by way of individual county, state and State Department notarizations.

Table 4

		Population (million)	GDP per capita (2005)	Market Cap World Bank (latest) \$ Mil	World Bank %
MidEast	Saudi Arabia	24.6	\$9,910	\$326,869	26.0%
MidEast	Iran	67.7	\$1,943	\$38,724	3.1%
Europe	Iceland	0.3	\$35,136	\$27,799	2.2%
Africa	Zimbabwe	13.0	\$426	\$26,557	2.1%
Latin Am	Venezuela, RB	26.6	\$4,939	\$8,251	0.7%
Europe	Cyprus	0.8	\$13,887	\$6,583	0.5%
Latin Am	Barbados	0.3		\$5,513	0.4%
Europe	Serbia and Montenegro	8.2	\$1,370	\$5,409	0.4%
Asia	Papua New Guinea	5.9	\$643	\$4,863	0.4%
Europe	Malta	0.4	\$9,618	\$4,097	0.3%
Latin Am	El Salvador	6.9	\$2,127	\$3,623	0.3%
Latin Am	Bolivia	9.2	\$1,061	\$2,200	0.2%
Latin Am	Costa Rica	4.3	\$4,499	\$1,478	0.12%
Africa	Mauritania	3.1	\$429	\$1,090	0.09%
Africa	Zambia	11.7	\$350	\$989	0.08%
Asia	Nepal	27.1	\$234	\$963	0.08%
Europe	Macedonia	2.0	\$1,889	\$646	0.05%
Africa	Tanzania	38.3	\$330	\$588	0.05%
Asia	Fiji	0.8	\$2,198	\$587	0.05%
Europe	Moldova	4.2	\$430	\$574	0.05%
Latin Am	Uruguay	3.5	\$6,246	\$354	0.03%
Latin Am	Honduras	7.2	\$985	\$338	0.03%
Latin Am	Paraguay	6.2	\$1,361	\$234	0.02%
Latin Am	Guatemala	12.6	\$1,734	\$232	0.02%
Africa	Swaziland	1.1	\$1,369	\$197	0.02%
Latin Am	Guyana	0.8	\$980	\$187	0.01%
Africa	Malawi	12.9	\$154	\$156	0.01%
Latin Am	Cayman Islands	0.05		\$130	0.01%
Africa	Uganda	28.8	\$270	\$103	0.01%
Asia	Mongolia	2.6	\$483	\$46	0.004%
Europe	Armenia	3.0	\$1,129	\$43	0.003%
Asia	Kyrgyz Rep	5.2	\$319	\$42	0.003%
Asia	Uzbekistan	26.6	\$684	\$37	0.003%

365.8

Our Recommendation

We believe that the current frontier market benchmarks have flaws that limit their utility in setting portfolio objectives. Benchmark weights of 50% or more in the Middle East or in Eastern Europe do not reflect the full set of opportunities that frontier markets can provide. Our recommendation is a blended benchmark combining the S&P/IFC Frontier Market Composite with the MSCI Frontier Market Index. (Table 5). The resulting blended benchmark has a greater weighting in the Middle East and Kuwait than we would like, but it is a compromise that could be easily leveraged in setting portfolio objectives. This combination also overcomes the problem of having countries that are already in the MSCI emerging market universe, although it does require using two benchmark providers.

Table 5

50:50 blend: MSCI FM + S&P/IFC Composite				
Africa	Nigeria	6.1%	Africa	17.3%
Africa	Kenya	3.0%	Asia	9.0%
Africa	Cote d'Ivoire	2.5%	Europe	30.5%
Africa	Mauritius	2.4%	Latin Am	5.7%
Africa	Tunisia	1.5%	MidEast	37.4%
Africa	Botswana	1.3%		100.0%
Africa	Ghana	0.3%	Countries	31
Africa	Namibia	0.2%		
Asia	Vietnam	5.3%		
Asia	Kazakhstan	2.3%		
Asia	Bangladesh	1.2%		
Asia	Sri Lanka	0.2%		
Europe	Slovenia	10.9%		
Europe	Romania	6.3%		
Europe	Croatia	4.9%		
Europe	Ukraine	4.0%		
Europe	Bulgaria	1.6%		
Europe	Estonia	1.2%		
Europe	Lithuania	1.1%		
Europe	Slovak Rep	0.3%		
Europe	Latvia	0.2%		
Latin Am	Trin. & Tobago	3.3%		
Latin Am	Jamaica	1.5%		
Latin Am	Ecuador	1.0%		
MidEast	Kuwait	16.1%		
MidEast	UAE	10.5%		
MidEast	Lebanon	5.0%		
MidEast	Qatar	4.0%		
MidEast	Oman	1.1%		
MidEast	Bahrain	0.7%		
		100.0%		

Source: Frontier Market Asset Management, LLC

Conclusion

Frontier markets are now officially recognized by several new indexes, and this will encourage more investors to participate in these markets. This may stimulate a virtuous circle of rising liquidity and rising valuations that will allow these countries to raise capital more easily and to allocate it more efficiently.

However, these indexes should not be interpreted as defining frontier markets in the sense that developed markets and emerging markets are defined by their characteristics of income and development. By definition every market that is not developed or emerging is on the frontier. We need to recognize that the current frontier market indexes are merely subsets of the overall frontier market universe. The indexes are largely liquidity based, yet as one friend said, investors in frontier markets are often looking for “today’s prices and tomorrow’s liquidity.” The best opportunities may lie in the most unlikely places... “on the road less traveled”.

About Frontier Market Asset Management

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

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