



## Diversification Snapshot: Frontier Markets in a Troubled World

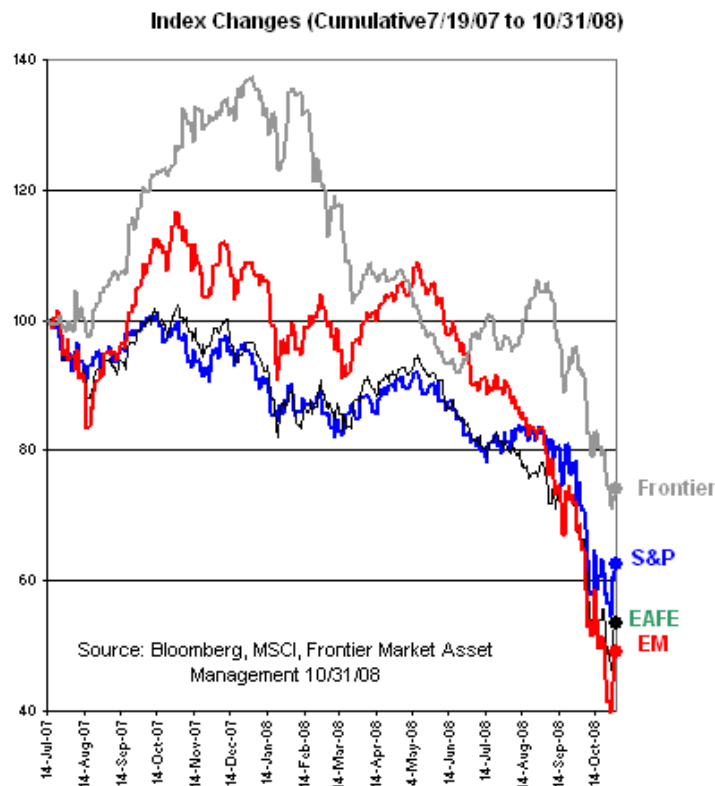
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The magnitude of the current crisis in the financial and economic systems of the world is unequalled by any event in our careers. Only during World War II did one see such turmoil and panic in financial markets.

During these challenging conditions in world financial markets, diversification is increasingly sought, yet hard to find. Anxious to reduce risk, many investors have sold whatever they could to raise cash, putting pressure on assets that otherwise may have good fundamentals. In this study, we examine the behavior of frontier markets during the past 16 months. It has been suggested that decoupling might occur between the developed and the emerging/frontier worlds based on the emergence of a middle class in many countries, and increases in the level of trade across borders within the emerging/frontier universe. There was a degree of decoupling until late 2007, but since then, world markets all have plunged, although the frontier has held up better than the rest.

### Exhibit 1



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It has been almost a year and a half 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 has been up and then down, while the DJIA closed at 9,325 on Friday, October 31, 2008, for a decline of 33%. Meanwhile, the S&P 500 is down 38%, the MSCI EAFE Index (Europe, Australia and Far East) has dropped 47% in dollar terms, and the MSCI Emerging Markets Index is down 51%. In comparison, our average of 28 Frontier Stock Markets has fared better, although it also is down 26%.

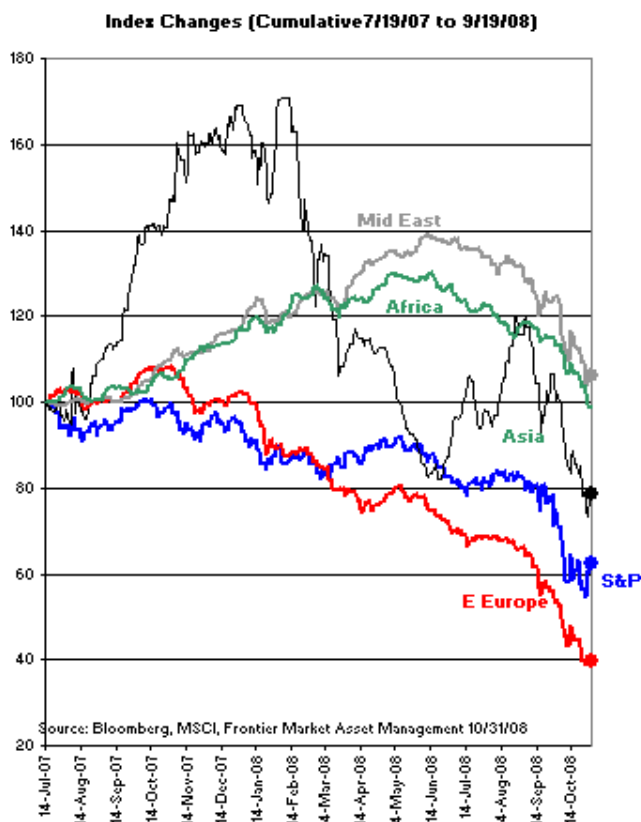
Other changes, shown in exhibit 2, have been dramatic: the dollar initially weakened 14% versus the Euro, but soared 19% since July; oil rose 99% to its July 3 peak, but fell 56% since, leaving it down 12% since July 2007; gold is down 23% in the past four months, while copper is down 49%; and 90-day T-bill rates dropped to near zero in the midst of the financial crisis. One piece of good news is that the level of expected inflation, as measured by the difference between the 10 year Government bond and the 10 year Treasury Inflation Protected Security, has narrowed to less than 1%.

### Exhibit 2

	Oil Brent Futures	Gold	Copper	Euro	3 mo T-Bill	10 Yr Gov	10 Yr TIPS	Expected Inflation
7/19/2007	74.4	677.5	7920.0	1.38	4.98	5.02	2.64	2.38
7/3/2008	147.7	934.5	8812.0	1.57	1.85	3.98	1.37	2.61
10/31/2008	65.6	724.6	4500.0	1.27	0.38	3.97	3.06	0.91
Chg 7/19/07-7/3/08	98.6%	37.9%	11.3%	13.8%	-62.9%	-20.7%	-48.0%	9.4%
Chg 7/3/08-10/31/08	-55.6%	-22.5%	-48.9%	-19.0%	-79.4%	-0.3%	122.9%	-65.1%
Chg 7/19/07-10/31/08	-11.8%	6.9%	-43.2%	-7.8%	-92.3%	-21.0%	16.0%	-61.9%

Source: Bloomberg, Frontier Market Asset Management, Oct. 2008

### Exhibit 3



Looking at the frontier markets in more detail, exhibit 3 shows the behavior of our sample of 28 frontier markets on a regional basis during the past 16 months. In the first year of the crisis, Eastern Europe was

hit hard, while Africa and the Middle East actually rose. Since July 2008, however, all regions are down, but the worst continues to be Eastern Europe by far.

**Exhibit 4**

	Frontier Markets Ave (28)	Frontier Asia (3)	Frontier Africa (4)	Frontier Europe (9)	Frontier Mid-East (12)
% Change 7/19/07-7/3/08	-2.2%	-3.4%	25.6%	-31.5%	38.3%
% Change 7/3/08-10/31/08	-23.8%	-17.1%	-21.6%	-42.9%	-23.1%
% Change 7/19/07-10/31/08	-25.5%	-19.9%	-1.5%	-60.9%	6.3%

Source: Bloomberg, Frontier Market Asset Management, Oct. 2008

Another measure of the behavior of frontier markets is the correlation of daily returns versus the S&P 500 Index. Because of holidays and the lagged impact of U.S. market, we have smoothed the correlation data by using the correlation over 90 day periods of five day returns. As shown in exhibit 5, the nature of the crisis changed dramatically in September 2008. All correlations shot up and frontier markets joined the club. From a credit problem in sub-prime mortgages, the crisis exploded into a freeze of credit markets following the bankruptcy of Lehman Brothers. This affected Eastern European banks severely because their dependence of borrowing abroad. Lehman's bankruptcy also led to a flight to quality in the U.S. dollar and a collapse of the dollar "carry trade" (playing the spread on low U.S. interest rates). The result was a soaring U.S. dollar and a plunge in many emerging market currencies. Some frontier markets were caught up in this. For example, when the South African rand collapsed, it dragged down currencies of its neighbors, which also fall within its currency block: the Botswana Pula, the Zambian Kwacha and the Namibian Dollar.

**Exhibit 5**

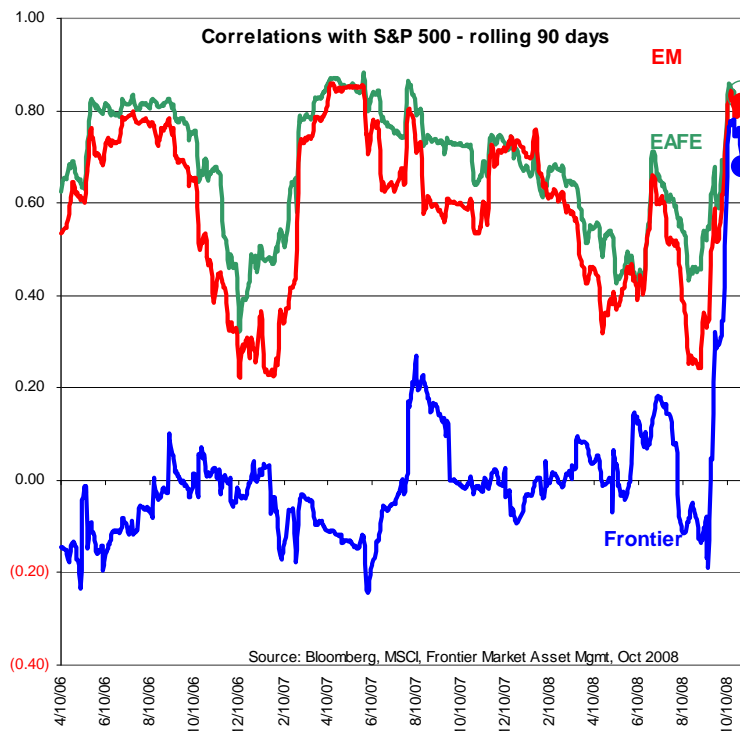


Exhibit 6 shows the correlation for each index or group over the initial period of the crisis through August 2008, in the recent 60 days, as well as the whole period from July 2007 to the present.

## Exhibit 6

Correlations	DJIA	R2000	EAFE	Emerging Mkts	Frontier Market Average (28)	Frontier Asia (2)	Frontier Africa (4)	Frontier Europe (9)	Frontier Mid-East (11)
7/19/07-8/31/08	0.97	0.90	0.61	0.53	0.00	0.05	(0.12)	0.31	(0.00)
8/31/08-10/31/09	0.99	0.93	0.84	0.82	0.67	0.37	0.34	0.75	0.53
7/19/07-10/31/10	0.98	0.92	0.76	0.71	0.07	0.24	0.17	0.60	0.37

Source: Bloomberg, Frontier Market Asset Management, July 2008

While all frontier markets have had higher correlations in the past 60 days, this trend has been especially noticeable in Eastern Europe and the Middle East.

## Conclusion

The current financial and economic crisis has now gone global, and has reached into most corners of emerging and frontier markets. The results continue to offer evidence that frontier markets provide useful diversification benefits; but markets dependent on global credit, such as those in Eastern Europe, have been quite vulnerable. In other countries, however, local investors tend to dominate, and they are much more concerned with local economics and local politics than with global credit problems. In Bangladesh, for example, foreigners represent less than 5% of trading volume, and the market has continued to do well. Ghana is another market with relatively few foreign investors, and perhaps that explains why it has been the best market in the world so far in 2008, up more than 30%. Moreover, most foreign investors in frontier markets 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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