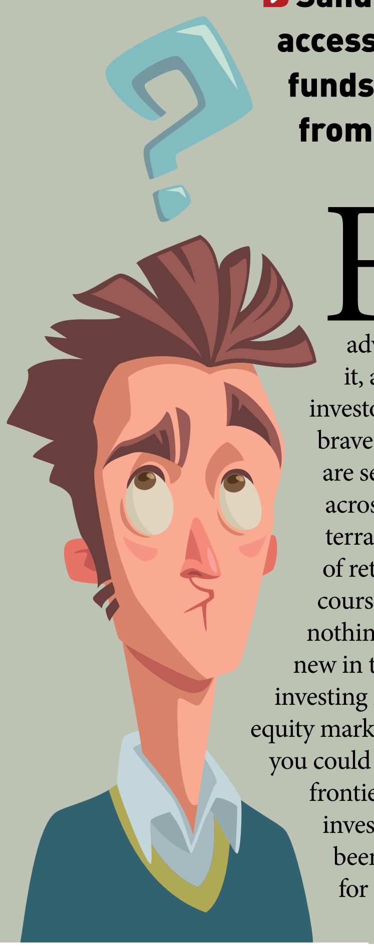
Summary
• MSCI classifies 33 countries as frontier markets, 24 of which are included in the MSCI Frontier Markets Index.
• Frontier doesn't mean less developed, and doesn't necessarily mean not as wealthy. The difference between frontier and emerging is that in emerging, the markets have more liquidity and transparency, better infrastructure. Governance is thought to be better, liquidity in terms of market turnover is higher, and companies are larger with bigger floats.
• A lack of correlation is a potential saving grace for frontier markers. Each individual market might be higher risk, but if they are put together in a portfolio they are much lower risk.
• The asset class can still be mispriced and under-researched, with low correlation with mainstream emerging market debt and very idiosyncratic compared to other types of emerging market debts, which tend to be much more systemic in nature.

Revelationary exploration?

Sandra Haurant looks at the current accessibility of frontier markets for pension funds and what differentiates these regions from emerging market geographies



Frontier markets has a ring of adventure to it, as though investors who brave this area are setting out across new terrain in search of returns. Of course, there is nothing inherently new in the idea of investing in frontier equity markets. "I think you could argue that frontier market investing has been going on for 150 years, but MSCI only came out with an index in 2007," Charlemagne Capital's Frontiers Fund manager Dominic Bokor-Ingram says.

MSCI (Morgan Stanley Capital International) produces a list of frontier market countries, as distinct from more mainstream emerging markets, according to its criteria. As MSCI says: "The MSCI Frontier Markets Indexes include large-, mid- small-cap, and provide broad representation of the equity opportunity set while taking investability requirements into consideration within each market. The MSCI Frontier Markets Indexes can be segmented by size, sector and geography, allowing for consistent global views and cross-regional comparisons. MSCI classifies 33 countries as frontier markets, 24 of which are included in the MSCI Frontier Markets Index."

The list covers countries in regions all over the world, and a quick glance shows that the scope is huge. From Argentina to Lithuania, from Kazakhstan to Tunisia, from Kuwait to Vietnam, and many more, there are countries that span the economic and political spectrum. Each year in June, MSCI reviews its list– a country that has until now considered out of bounds, or standalone, may join the ranks of the frontier markets, while a frontier market may be promoted to an emerging market.

Argentina, for its part, failed to move from a frontier market to an emerging market this year, while Nigeria is currently under review and may be changed from a frontier market to standalone following: "… a continuous deterioration of the market accessibility after the introduction of restrictions on foreign currency trading in the first half of 2015 and the resulting reduction of foreign exchange market liquidity," according to MSCI.

Differences

But some working within the frontier market arena maintain that MSCI's list should not be seen as the beginning and end of the asset class. Bokor-Ingram says: "The way to look at frontier markets is probably as a subset of emerging markets. The reason, generally, that they are classified as frontier is that they have recently come out of some regime that was not conducive to capitalism." He adds: "Frontier doesn't mean less developed, and doesn't necessarily mean not as wealthy. You've got counties like Kuwait, which is among the richest countries in the world. You've got countries like Argentina, which 10 years ago were emerging markets."

Dragon Capital CIO Bill Stoops has been based in Vietnam, officially a frontier market according to MSCI, for more than a decade. "The difference between frontier and emerging is that in emerging, the markets have more liquidity and transparency, better infrastructure. Governance is thought to be better, liquidity in terms of market turnover is higher, and companies are bigger with bigger floats," he says.

There was talk of Vietnam being placed on the watch list to be considered for reclassification to emerging market, but it remains frontier. For those who have been invested here for some time, the benefits of having 'got in' early could be significant, if and when the country is reclassified: "There is both a great domestic economy and an export machine, and the export is proven by very robust foreign direct investment," Stoops says. "Vietnam is politically stable, it has good social and cultural trends, and it's got perfect demographics. Pound for pound it's hard to find a better market that ticks all the boxes like Vietnam does."

A step into the unknown?

Nonetheless, while countries like Vietnam look good on paper, the reality of investing in frontier markets can still feel like a step into the unknown for pension funds, perhaps too great a risk to take. "You do get big institutions buying direct stocks in Vietnam now, but it's still an exotic small market for pension funds and endowment funds," says Stoops.

It is a perception that Bokor-Ingram would challenge. He maintains that individual countries may be higher risk than individual emerging markets, for example, but the fact that these countries have for some time operated outside the global financial machine is what makes them a safer bet, he asserts: "Your average frontier equity market is 5 per cent owned by foreign investors, while your average emerging equity market is 50 per cent owned by foreign investors, so global capital slows have much less impact on frontier markets," he says.

"The second point is that frontier markets have much lower levels of debt, and particularly lower levels of dollar debt, than emerging or developed markets," he adds. They may have had regimes that could not borrow, or high inflation may have prevented them from doing so, once more ensuring they are sheltered from certain types of financial turbulence. Much lower debt levels obviously create less correlation to global events, interest rate events, strong dollar events and so on.

This lack of correlation is a potential saving grace for frontier markers. "Each individual market might be higher risk, but if you put them together in a portfolio they are much lower risk. And this is also the case because they are being driven by domestic factors," he says. After all, although there are commodity price issues that might affect all countries, in many ways they are far removed, even isolated, from one another, economically.

"If something happens in Argentina that reverses the reform process, that has no impact on what is happening in Pakistan or Vietnam or Georgia. Whereas, if something happens in China, it will impact on every single emerging market."

Fixed income

Meanwhile, in the fixed income sphere, frontier markets have also become a talking point. In a low yield, low interest rate environment, pension funds are obliged to look further afield in search of better yields, and some argue that frontier markets could well provide a suitable destination. Frontier markets on the fixed income side have not yet carved out their own asset class in quite the same way as equities, and are still considered part of the broader emerging markets space, but they are just as interesting a place to be, BNP Paribas Asset Management deputy head of emerging markets fixed income JC Sambor says.

"It is a very attractive asset class because it is still mispriced, under-researched, low correlation with mainstream emerging market debt and very idiosyncratic compared to other types of emerging-market debts, which tend to be much more systemic in nature," he says.

However, while low yields are pushing pension funds towards opportunities such as frontier, there are still issues in terms of accessibility. J.P. Morgan Asset Management head of emerging market debt and client portfolio management Zsolt Papp, says: "The challenge you have as an investor is that there aren't any indices out there that you can simply replicate or that you can use in order to build a portfolio."

Accessibility and liquidity remain important factors, too, along with the cost of entry, says Sambor.

"Even though it's a growing asset class, it is really capacity constrained," he says. "But I think the fact that it's capacity constrained makes the case that you can get very good risk reward – the cost will be higher than in mainstream emerging market debt, but the performance should be better."

This is not, then, a straightforward area of investment, and it is one which is at once relatively constrained and hugely wide reaching. But those working within frontier market investing are keen for pension funds to at the very least find out more before writing off what can be a hugely rewarding space, after all, says Bokor-Ingram.

"People need to get out and do their own work and form their own ideas. Any time I take any client to a frontier market it is a revelation."

Written by Sandra Haurant, a freelance journalist