FRONTIER MARKETS

Forget the BRICs; Zambia, Estonia and Pakistan are the place for alpha investors

Frontier markets across Africa are yielding bigger gains for investors. (AP Photo/Tsvangirayi Mukwazhi)

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The search for superior, uncorrelated risk-adjusted returns continues, and savvy investors such as

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endowments and family foundations are turning their attention to the frontier markets. Such markets exclude the BRICs, many of which posted sizable equity returns of over 30% last year, including Nigeria, Estonia, Pakistan, and Kenya. The MSCI Africa sub index posted one-year returns of over 60%. By comparison, the BRICs (Brazil, Russia, India and China) grew slower and sluggish—for example, around 4% on the Shanghai index and -2% on Brazil's Bovespa.

A set of well-known factors bind these seemingly random countries. Solid debt and deficit dynamics; attractive labor trends, favorable demographics and upward mobility; and important productivity gains all make for a compelling economic growth story. However, there are two areas where perceptions of frontier economies are really changing: risk and liquidity.

In regards to risk, investors are beginning to better understand the significant benefits of delineating between risk, measurable and possible to calculate, and uncertainty, which is not. Like anywhere else, investors who can tap into on-the-ground networks and relationships have an advantage with risk management. But thankfully meaningful, the task of risk assessment has gotten easier with increases in transparency around economic and political information, data flows and widely available regulations over jurisdictions. The transition to western-styled democracy and fully transparent and liquid capital markets will be bumpy, but the uncertainty arising from these growing pains should be viewed in the context of an upwardly sloping trend line of progress which will almost certainly occur over a relatively short time line.

Correlations between frontier and developed stock market returns are around 0.75, compared to roughly 0.90 between developed and emerging economies such as the BRICs. Country risk premiums are close to those of the broader emerging markets. With proper risk management tools, this implies that investors can garner significant diversification benefits. The lower correlation between frontier and developed markets points to risk factors that are orthogonal to the global risk-on, risk-off theme that has captivated markets over the past five years. Frontier markets provide opportunities to step away from the global macroeconomic themes and focus on the micro stories on the ground, thus providing a better environment to identify unique investment opportunities. Smart investors are looking for great opportunities that are driven by company-specific issues from which they can analyze and profit.

In terms of liquidity, both equity and debt markets – international and local – have grown considerably over the last five years. Today, with a market cap of more than $1 trillion, the universe of stock markets boasts more than 8,000 listings across broad sectors with notable risk/reward profiles in financials such as banking and insurance, consumer goods, and telecommunications companies. A number of commentators erroneously believe investing in frontier markets is simply expressing a commodity trade. To assume this would be miss out on some of the more significant opportunities in these burgeoning markets such as in the logistics and telecommunication sectors. Moreover, to put a finer point on this, today Africa has almost 20 stock exchanges, with just over a thousand listed equities; more than 85% of these stocks are non-commodity related businesses.

Furthermore, to the liquidity point, an increasing number of jurisdictions offer the opportunity to short the markets, which would have come in handy in places like Ukraine and Mongolia (down 35% and 19%, respectively last year), which both saw stock market declines on the back of political uncertainty. Associated funding costs, such as borrowing rates in the repo markets, have compressed, also reflective of the maturing of the market.

Many traders now believe the major frontier markets are poised for an uptick in liquidity, similar to the takeoff seen in more emerged markets like Turkey. In under a decade, the Turkish equity markets went from funding costs as high as 8% and an ability to write maximum ticket sizes of only around $10 million, to today where funding costs of 0.5% and trading sizes of $200 million in key names are commonplace. Daily volumes and average trading sizes in frontier markets like Kuwait and Saudi Arabia are already over $20 million, and up to $15 million per day in places like Kenya and Nigeria. While these volumes are still relatively small, when compared to developed markets where investors trade billions of dollars in single company names, the trend for greater liquidity and lower funding costs points upwards.

The bond markets too offer a lot of opportunities. For example, coupons in the high single digits are not unheard of, particularly for local corporate issuance of financial institutions stocks such as those in Nigeria. While taking on the foreign exchange risk of investing local debt might be a step too far for some investors, frontier market issuance in international bond markets also promises attractive yields.

The hugely successful Zambia sovereign debt issue from last autumn (the $750 million 10-year bond with a yield of 5.625% was over 12 times oversubscribed) has set a precedence with international bond issuance from the Dominican Republic, Mozambique, and Kenya among those believed to come to market this year.

Against the backdrop of regulatory and macroeconomic uncertainty in developed economies and ongoing weaknesses in more mature emerging economies investing in the frontier markets is worth a serious look. The global investment mood appears to be turning from benchmark hugging towards alpha-seeking, and expectations of a rotation out of relatively risk-free fixed income investments into riskier propositions such as equities is underway. The smartest global investors who recognize this will undoubtedly continue to lead the charge into the frontier.

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