June 30, 2011

Exploring the Final Frontier

Tracking the Economic Expansion of Small Emerging Markets

The faint of heart should venture no further! Possible upside potential with unknown downside risk awaits those investors who pursue growth in the smallest corners of the globe. These "Frontier Markets" are a subset of emerging markets and are differentiated from other emerging markets by their very small market capitalization and liquidity challenges. Figure 1 (below) lists the 26 countries found in the MSCI Barra Frontier Markets Index (May 2011).

FIGURE 1: MSCI Barra Frontier Countries (May 2011)

Argentina	Kazakhstan	Oman	Slovenia
Bahrain	Kenya	Pakistan	Sri Lanka
Bangladesh	Kuwait	Qatar	Tunisia
Bulgaria	Lebanon	Romania	Ukraine
Croatia	Lithuania	Trinidad/Tobago	U.A.E
Estonia	Mauritius	Serbia	Vietnam
Jordan	Nigeria		

Source: The Research Foundation of CFA Institute, 2011

The economic characteristics of frontier markets differ markedly from those of developed nations. For frontier countries to succeed, they must develop four critical economic areas – labor, capital, technology, and raw materials.

Labor

Demographics are a powerful force in emerging markets. Young workers in these countries are a stark contrast to the aging population of developed countries. Comparative advantages can be created by low wages, a young work force, and improving productivity via education and technology. Countries with these advantages have been attracting international manufacturing investments. Those countries that can add educated populations to this list can attract outsourcing opportunities in more sectors than merely manufacturing. Call centers, and in many cases, even professional jobs are being relocated to those nations with growing educated populations. Young, educated, populations are critical to growth in frontier nations.

Capital

Most developed countries have loan-to-deposit ratios over 100%. Many of the credit markets in frontier nations (with the exclusion of Eastern European countries), by contrast, are much more conservative, with

loan-to-deposit ratios around 70 percent. Because of the 2008 financial crisis, new severe regulations are being put in place in over-leveraged developed countries. As a result, returns on capital will suffer. This makes the possibilities in emerging markets more attractive by comparison.

Even though capital investment in emerging markets is attractive, the under developed consumer financial sector that characterizes frontier countries in Africa and Asia, makes investment difficult. The lack of funding from local banks in these frontier markets has launched an industry called microfinance. The goal of microfinance is to provide financial services to low-income clients who lack access to traditional banking services. The under-served populations in these markets have latched onto microfinance as a way to obtain credit with which to build small businesses. The availability of credit allows people living in poverty to climb out of the cycle of subsistence living and move up to the middle class.

Technology

The benefits of technology have greatly influenced the pace of growth in frontier markets. Any technology that reduces the cost of building infrastructure for modernization is extremely beneficial to under developed countries.

Recently, the biggest boon has been the arrival of mobile phones. With cellular technology, there is no need for traditional landline infrastructure, so these countries can leapfrog that step and move straight into wireless communications. The ability to communicate with business partners is invaluable for increasing workforce productivity. With the advent of smart phones, the added cost of purchasing a personal computer will be unnecessary. Further, the ability to make payments and browse the internet via the mobile devices, allows technologically savvy populations unprecedented access to services and information, which, in turn, can lead to explosive growth.

Raw Materials

Lately, frontier countries have put pressure on the world's commodity markets as they increase their consumption of basic industrial commodities to build infrastructure and manufacturing. These are accompanied by increased energy demands as manufacturing is globalized and the standard of living around the world improves.

Most developed nations have no desire to increase their resource extraction because of environmental concerns. This leaves space for developing countries to extract precious resources and export them to end users, or, better yet, utilize them internally. These resources include, but are not limited to the following: oil and gas, minerals, natural gas, and farmland. Effective resource management that reinvests in the local economy is necessary if emerging economies wish to grow beyond extraction. Countries that do not

look beyond extraction as the basis of their economies are doomed to failure when their natural resources run dry.

After surveying the landscape, if the four areas of labor, capital, technology and raw materials are well-structured in a frontier country, it deserves a second look. As with all markets, each frontier country's stock market reflects future expectations. If strong growth is predicted, its stock market will price in the optimistic prediction, making actual returns subpar. In fact, investments in frontier economies will only be rewarding if the market prices are not "irrationally exuberant." An astute investor will recognize that there are country-specific instances when future economic growth will be higher than past growth and current expectations for growth are underestimated. In these situations, stock returns will successfully mirror the growth in the economy, rewarding the patient investor.

- Rachel Wakefield, CFA