Investors look beyond BRIC

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With a lower level of correlation to the global credit crisis, developing markets are attracting investors looking for extra alpha beyond the trendy markets of Brazil, Russia, India and China (BRIC). At the recent World Alternative Investment Summit Canada, three experts shared their views on the risks and opportunities in the alternative developing markets.

As the BRIC economies become more integrated with developed markets, risk has become mitigated. This has attracted a lot more investors, thus creating a more efficient marketplace and, unfortunately, reducing the potential for the phenomenal outsized returns these markets have experienced over the last few years.

Investors are looking to alternative emerging markets, like the Middle East or Latin America, or in some cases frontier markets — those markets not developed enough to be included in the MCSI Emerging Markets Index — as a way to achieve double-digit gains.

It has been a profitable exercise over the last year if you've been invested in the right markets, because the less-developed markets have not been affected by the subprime crisis to the extent of most of the world's major markets, says Alison Graham, a principal with New York-based hedge fund firm Voltan Capital Management, which specializes in frontier market investing.

"Most of the emerging markets, including the BRIC countries, are down anywhere between 8% and 12%. The one question you hear is how has the U.S. subprime crisis affected emerging markets? In the frontier markets where we invest, the impact has been fairly minimal," she says. "In terms of the 60 or so countries that we do invest in, overall there have been a handful that have done really well this year. For instance, Ghana is up 40%, Lebanon is up about 50% and Tunisia is up 27%. Even with all the turmoil we've experienced, there are still a lot of countries out there that are doing quite well."
Graham says there are some exceptions, where frontier markets have been hit hard by the contraction in cheap debt that was available to them in the earlier part of the decade.

"Kazakhstan was borrowing a lot of cheap U.S. dollars and lending out that money during [a period of] high interest rates and making a terrific margin. With the U.S. credit crisis, that party came to an end and the banking sector fell by 50% to 60%. That's one very specific example where the credit crisis had an impact. For other markets, troubles tend to stem from the general global atmosphere of risk aversion. Markets like Ukraine and the Balkans had been in the hole prior to the crisis," she says. "Other than that there are a couple of countries that have very idiosyncratic issues like Georgia, which has lost a lot of capital value due to the war."

BRIC countries are still a lynchpin of developing market investing. Just as the BRIC countries earned their growth as satellite producers of goods for the developed market, many of the upstart markets are those that are becoming producers of resources for the BRIC countries.

One country benefiting from this role is Peru, says Ernesto Higueras, president of Intercapital SAB S.A., a private Peruvian brokerage firm and investment bank. Higueras says Peru has become a strategic resource provider of iron ore. Since its coastline is on the Pacific Ocean, it's ideally placed as

a port to emerging Asia. He notes that over the last few years, investment in the country has exploded, with $25 billion being invested in the iron ore industry alone.
Graham says similar relationships are forming in Sub-Saharan Africa, where markets are growing due to substantial investment from the Middle East and China. "One of the interesting dynamics we've seen in Africa is the extent to which China and the Middle East have become major investors throughout Africa. Everywhere you go, but particularly in natural resources and agriculture, you will find sovereign wealth funds and the Chinese government invested in Africa," she says.

Investors usually have to get directly involved with private equity or direct infrastructure investment to benefit from these types of deals, Graham says. "In Africa, the equity markets have never been the most efficient ways to raise capital. If you come in as portfolio investor, you're very limited in what you can buy, excluding what's offered in South Africa and maybe Nigeria," she says. "If you look at other countries in the region, Botswana only has only 12 listed securities, Uganda has seven — literally only a handful of names. The rest of the region is a much better play for private equity than it is for listed securities."

Mustafa Saiyid, from the Monetary and Capital Markets department at the International Monetary Fund (IMF), warns that investors also have to be wary of the rapid growth within both the emerging markets and the frontier markets. Along with the growth is coming skyrocketing inflation, and he's not sure if the central banks of many of these countries are going to be able to effectively balance the two competing needs.

Saiyid also says the ability to borrow internationally has become more difficult. "At the same time [as rising inflation], there are these high borrowing costs for these countries to issue debt on the global markets," he says. "They have very difficult monetary policy to contend with. Central banks in these countries have to decide whether they should be fighting inflation or whether they should be accommodative of growth."

"It's complicated policy-making times for emerging markets. If you look at the way emerging markets have actually been responding, they've actually been keeping real interest rates negative," he says.
Graham acknowledges the inflation risk, and says it factors into what countries she decides to put money in. In high inflationary markets, she looks for companies that can take the inflation risk off their balance sheet.

"If you're talking about a country that has 7% to 9% inflation, but the economy is growing strongly, that type of country we are okay investing in," she says. "We try to find a supply/demand dynamic where companies can pass on the inflationary costs to the consumer."