

## India? How 2006! Fund Managers Seek New Frontiers

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With emerging markets one of the hottest investments of the past few years, mutual funds that own stocks in developing countries like Brazil, South Korea and Russia have become practically a mainstream holding.

So meet the "frontier markets" of Bangladesh, Cote d'Ivoire, Jamaica, Slovenia and many other countries in Africa, South Asia, Eastern Europe and the Caribbean. Many are subject to political uprisings, hyperinflation, extended power outages and devastating natural disasters. Information can be hard to come by, and investor rights are usually sketchy. Transactions involving a few million dollars of shares can take weeks to complete.

Frontier-market investing isn't new -- Standard & Poor's Corp. created a frontier-markets index 11 years ago as the boldest hedge funds for wealthy investors ventured into the territory. But it is surging in popularity in a development that suggests more of these stocks will show up in ordinary investors' mutual funds during the next few years.

Emerging-market stocks have evolved from virtual pariahs as recently as 2003, when many economies were trying to overcome the financial crises of 1997-98, to broad acceptability during the past two years. Emerging-market mutual funds world-wide saw a record amount of net new money last year of \$22 billion, up from \$20 billion in 2005, according to Emerging Portfolio Fund Research.

Frontier markets appeal to steely nerved investors who think that, as some emerging markets more closely resemble developed countries, investors have to move out further on the risk spectrum to find undiscovered stocks. Interest also has been driven by burgeoning demand from China and India for many of the commodities and natural resources found in South America and sub-Saharan Africa.

Many of the opportunities, for now, are open only to institutional investors. A few mutual-fund companies offer limited frontier exposure through emerging-market mutual funds, including Franklin Templeton, Eaton Vance, T. Rowe Price and Fidelity Investments. In rare cases, some broader global funds may even dabble on the frontier. DWS Global Thematic Fund, for instance, owns stocks from Egypt, Kazakhstan and Pakistan, says Oliver Kratz, portfolio manager of the \$1.4 billion fund. "I'm going to spend more time in Africa (this) year and see what's coming from there," he adds.

Thanks in large measure to money pouring into these markets from hedge funds and other investment pools for big investors, many frontier stocks have soared. The S&P/IFC Frontier Index, which measures performance of stocks in 22 countries, has returned an average of 37 percent a year during the past five years. That tops the average 25 percent-a-year return for the Morgan Stanley Capital International Emerging Markets Index, and is about five times the total return of the Standard & Poor's 500-stock index.

The average, however, masks the risk and often large discrepancies between these countries' returns: Namibia was the top achiever with a 126 percent return in dollar terms, while Tunisia was at the bottom with an 8 percent dollar decline.

Skeptics point out that a lot of money is flowing into immature companies that are nowhere near ready for prime time. Stocks represented in the S&P/IFC have a combined free-float market capitalization of about \$40 billion -- smaller than some individual emerging-markets stocks, and not even half the market capitalization of South Korea's Samsung Electronics Co.

Mark Madden, who manages about \$12 billion in emerging-market stocks for OppenheimerFunds in New York, says this trading illiquidity makes investing in frontier stocks impractical for big mutual funds like his. He suggests that most of these markets are more appropriate for investment by corporations or private-equity firms that, unlike most mutual funds, aren't subject to potential client redemptions or portfolio rebalancing.

There are no strict guidelines for what qualifies a country as an emerging market, rather than as one of the developed markets, which includes the U.S., Western Europe and Japan. Morgan Stanley Capital International and S&P consider macroeconomic criteria like per capita income, and market factors like ease of trading or any curbs on foreign investors, when assigning classifications.

But determining status is an inexact science, and even some of the more developed emerging markets have been known to slip back into bad habits: witness Thailand's decision last month to impose restrictions on foreign investment that sent its stock market reeling 15 percent in one day before some of those restrictions were eased.

Even so, many fund managers say places such as South Korea, Taiwan and the Czech Republic exhibit developed-market characteristics and soon should graduate to that status. In their place, emerging-market indexes need to replenish with countries earlier in the development stage.

Many investors believe the frontier countries are in the same position as emerging markets 10 to 15 years ago -- following the path of other successful developing countries to develop modern corporations and viable stock exchanges with strong growth potential for investors.

Fifteen years ago, veteran emerging-markets stock picker Mark Mobius, who manages Templeton Emerging Markets Small Cap Fund, considered Thailand, Poland and Hungary to be frontier markets. Today, he points out, many of their stocks are followed by analysts at Wall Street firms, their companies adhere to international accounting standards and they have dollar-denominated shares that trade in London or New York. "You'll see the same thing happen with some of the frontier markets today," he predicts.

Frontier markets tend to have little correlation with events like the outlook for U.S. interest rates, strength of the yen or Europe's economic-expansion forecasts. Instead, they tend to rise and fall in response to the whims, prejudices or unusual experiences of local investors, whose behavior has a logic that initially might not make sense to outsiders.

For instance, a few years ago, the International Monetary Fund cut off funding to Zimbabwe. Violent land reform was scaring off foreign investors. The price of the African nation's biggest export, tobacco, was falling while the price of its biggest import, oil, was rising. So locals did the only thing that made sense to them: they went on a stock-buying spree, driving the market to its highest levels ever.

That is because local Zimbabwe investors face restrictions on investing abroad, and, with the banking system a mess, stocks looked like the least-unsafe place to keep their savings.

Even in cases where the frontier company has a U.S. or European parent company, investors may have to dig deep to get questions answered about quirks in company operations.

Sechaba Brewery Holdings Ltd., for instance, is majority owned by Anglo-American brewer SABMiller PLC. As Botswana's beer and Coca-Cola bottling company, Sechaba has chalked up an annualized return of about 18 percent since mid-1997. Abbreviated versions of its annual reports are available online and PriceWaterhouseCoopers audits the company's results.

On a recent trip to one of the breweries, an investor asked Sechaba officials why it used giant 100-pound bags of sugar that required a forklift to move, rather than smaller bags that could be transported in the warehouse more cost efficiently. The answer was that sugar is a valuable commodity in Botswana, and the cumbersome bags were aimed at preventing employee pilfering.

Asked last month about the exchange, a representative of Kgalagadi Breweries, part of Sechaba, said transporting sugar in bulk wasn't aimed at theft prevention, adding: "In 29 years of operation, we have never had an incident of theft of sugar or any of our products."

Sometimes the underdeveloped nature of a country can work to a company's advantage. Take Zambeef Products PLC, a popular stock with U.S. investors looking at Africa.

Given the poor quality of meat available in Zambia's local markets, the company decided to buy farmland and raise cattle. Because the retail market was too immature to handle the amount of meat it wanted to sell, Zambeef had to create its own nationwide distribution network. It uses this network to sell chickens, eggs, milk, even leather shoes. Its shares were up 59 percent in dollar terms last year.

One of the biggest drawbacks to frontier investing is the limited daily trading in many stocks: For instance, only \$50,000 of Zambeef shares trade daily, on average.

If investors bet on frontier markets in hopes that the countries will evolve into more mainstream markets, they are taking a chance. There's always the risk that development will never materialize.

Many investors expect to be amply rewarded for taking that risk. "We want bargains," Mr. Mobius says. But given the rising interest in frontier markets from hedge funds and other traders, "that's just not the case for many of these markets."

Consider Vietnam. It was added to the S&P/IFC Frontier Index in December, reflecting growing investor optimism about the country's development. The main Ho Chi Min City Index doubled in value last year, with foreigners big buyers of Vinamilk, a leading dairy producer, and Saigon Commercial Bank, the larger of Vietnam's two listed banks. Shares there trade at about 26 times estimated 2006 earnings, above the S&P 500's trailing price/earnings ratio of 18.

Mr. Mobius says his Emerging Markets Small Cap Fund will place greater emphasis on the relatively small companies in more established emerging markets like Taiwan or Malaysia, rather than on the bigger stocks in frontier markets.

"Frontier is good if the stocks are cheap and overlooked," he says. "Otherwise, you're better off in the bigger emerging markets ... . A lot of these (frontier) markets have been picked over, and their prices have already gone up ... . Very little money going into frontier markets can drive prices up quickly."