Newfound Strength in Frontier Markets

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THREE years ago, when Joseph Rohm, manager of the T. Rowe Price Africa and Middle East fund, visited Lagos, the capital of Nigeria, he was chaperoned by guards carrying semiautomatic weapons. These days, he strolls the streets alone. “I feel safer in Lagos than I do in Johannesburg,” said Mr. Rohm, a native of South Africa.

That transition underscores the changing reality of so-called frontier stock markets, those that are less developed than emerging markets like Brazil, China and India. Countries, whole regions even, that a few years ago were dismissed as perilous to both body and bourse have come into stock market vogue.

Big investment companies have rolled out mutual funds and exchange-traded funds that put all or at least a big chunk of their money in frontier regions. Mr. Rohm’s fund, one of the older offerings, began in 2007. As of the end of April, it had invested about three-fourths of its $207 million in countries including Nigeria, Kenya and Qatar. For the 12 months through June, it returned 17 percent.

Two leading providers of exchange-traded funds, Claymore Securities and Invesco PowerShares, have also introduced frontier products. The Claymore/BNY Mellon Frontier Markets E.T.F. invests around the world, while the PowerShares MENA Frontier Countries Portfolio focuses on the Middle East and North Africa. Both are built upon frontier-market indexes and invest passively.

The frontier pitch resonates at a time when the American and Western European economies are struggling and United States interest rates are sagging. And returns in several of the leading emerging stock markets, Brazil, China and Russia, have faltered this year, after surging in 2009. “We view frontier markets as attractively valued compared with emerging markets,” said Constantine Papageorgiou, a senior portfolio manager at Acadian Asset Management in Boston. “They didn’t participate in the huge run-up in 2009 that you saw in the emerging markets.”

Frontier investing is a new-enough phenomenon that professionals disagree on which countries make up the sector. Different managers and index providers include different names. The Claymore E.T.F., for example, has Chile and Poland among its top five holdings, though neither is part of the MSCI Frontier Index. The index includes such diverse countries as Argentina, Romania, Kenya and Kazakhstan. It rose 0.66 percent, including dividends, in the first six months this year, compared with a negative total return of 7.57 percent for the Standard & Poor’s 500-stock index. The frontier index has been helped along by positive returns in three of its important markets — Nigeria, Kuwait and Qatar.

Almost everyone, including MSCI, puts Nigeria in the frontier category. “I get people asking, ‘Who’s the next Brazil?’ ” said Adam J. Kutas, manager of the Fidelity Emerging Europe, Middle East and Africa fund. “I answer without hesitation that it’s Nigeria,” because it also has a large population and a huge base of natural resources.

Nigeria holds hefty oil reserves — the world’s 10th largest, according to the Central Intelligence Agency. For years, its riches produced unrest, as residents of the oil-producing Niger Delta rebelled against what they saw as too small a share of the profits. Lately, the delta has stabilized, and the country, formerly a military dictatorship, has had several democratic transitions.

Rising commodity prices have helped Nigeria and several of the leading African economies, which tend to be resource-rich, says Paul Collier, director of the Center for the Study of African

Economies at Oxford University. “These countries are the last frontier for natural resource discovery,” Professor Collier said. “With high commodity prices, it’ll all get discovered. ”

At the same time, policy makers in places like Nigeria have tamed hyperinflation and liberalized trade, he said. That combination of resource wealth and macro stability is attracting investors. Many but not all of the frontier countries are richly endowed with commodities. As expected from economies on four continents, they’re diverse. Kazakhstan, for example, unearths oil, metals and mineral, while Argentina sells soybeans, corn and wheat. Vietnam excels at manufacturing.

Because of this diversity, their stock returns tend not to move in lock step with those in developed and emerging markets, Mr. Papageorgiou of Acadian said. They can zig when the developed world zags. And returns in the frontier regions even tend not to track one another.

“Eastern European markets will trade in line with each other but very differently from the African countries,” Mr. Papageorgiou said. Thus, a small frontier allocation can provide diversification in a portfolio.

All of this does not mean that these locales have become low-risk. “Some people think that noncorrelation means that frontier markets always will be up when everything else is down,” said Gregg I. Wolper, a senior fund analyst with Morningstar. “That’s not true. They’re not a miracle drug. In the bear market, they got hit hard, so it’s not that they’re protected.”

Some frontier countries remain more vulnerable to corruption and political crises than the typical developed market, said Darrell S. Zechman, a Chicago-based consultant with Towers Watson Investment Services. “They’re highly volatile, so you need a very long time horizon,” Mr. Zechman said.

Even so, he said he agreed with arguments for investing in them. “They’re relatively diverse, populous and growing fast,” he said. “They’re not fully established, but they do merit consideration. People were saying the same kinds of things about emerging markets 15 years ago.”
So what might be an appropriate frontier allocation for a long-term investor who already has a diversified portfolio and can tolerate the risks? Estimates from money managers who operate in the sector range from 2 to 5 percent.

But Mr. Wolper of Morningstar was skeptical about investing anything at all. “International funds and emerging market funds put very little money in frontier markets,” he said. “You can build a nice international portfolio without a frontier markets fund.”

Even if you believe that frontier countries will grow far faster than the developed world, you have to deal with the practicalities, including cost, of investing in them, he said. Frontier funds tend to be more expensive than average and have short records. “They could have great potential, but you can’t simply assume that you’ll get great returns,” Mr. Wolper said.

ANYONE who believes that frontier markets will rise relentlessly should recall 1978, said Mr. Kutas at Fidelity. That was when Time magazine named Deng Xiaoping, who led the overhaul of China’s economy, as its Man of the Year.

“That’s when the world came to the idea that China was opening, and that’s quite a few years ago,” Mr. Kutas said. Since then, the economy has boomed, but the stock market has been on a roller coaster — sagging, for example, during and after the Asian financial crisis that began in 1997. “What I’m saying is that a lot of these trends are true, but you can go through periods of sharp volatility.”