

# MyConsultant

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Prior to joining JANA in 2007, he held the position of Portfolio Manager World Equities with Suncorp Investment Management (SIM) for a period of five years. Prior to assuming this role, Michael held a number of positions within the Wealth Management arm of the Suncorp-Metway Group, including Research Manager (external funds), Manager Research & Technical Strategies and Product Manager (retail unit trusts).

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## Frontier markets investing

The idea of investing in Frontier Markets equities is not new. However, the region's recent strong returns in contrast to disappointing performance from emerging markets has seen it re-emerge as a topic of interest. JANA has taken another look at the asset class to evaluate its credentials as a 'stand-alone' investment category.

### 1. Background

The term "Frontier Markets" can be traced to 1992 when it was used by the International Finance Corporation (IFC) to describe a subset of emerging markets that are smaller, have lower market capitalisation and lower liquidity than the more developed emerging markets.

In general, institutional investors refer to frontier markets as countries that are considered less economically developed than emerging markets countries. However, some might consider this an unfair description of frontier market countries such as Qatar, where the GDP per capita is US\$106,000.

The point at which a country moves from frontier to emerging, or even when a frontier market is considered to be "investable", is also somewhat arbitrary. For instance, MSCI has 34 countries classified as Frontier Markets, while only 26 are included in the investable index. As index providers utilise different market classification, there seems to be little agreement amongst institutional investors as to how to classify a

country as frontier or emerging. In JANA's view, frontier markets can be defined as economies, which may be developed or underdeveloped, but which have underdeveloped equity markets.

These markets are characterised by risks and limitations, such as small size, low liquidity, low level of foreign investment and access to capital, equity market or currency restrictions, poor transparency, corruption and weak regulatory frameworks. It should be noted that many of these risks can also be observed in some emerging markets.

### 2. What are Frontier Markets?

There are currently 26 countries in the MSCI Frontier Markets Index (see table below). It is important to note that index composition changes periodically and frontier market indices are perhaps the most subject to flux of all indices. MSCI has advised that coinciding with the May 2014 Semi Annual Index Review, Qatar and the United Arab Emirates will "graduate" from frontier and be reclassified as emerging markets.

Europe	Middle East	Africa	Asia	South America
Bulgaria	Bahrain	Kenya	Bangladesh	Argentina
Croatia	Jordan	Mauritius	Pakistan	
Estonia	Kuwait	Morocco	Sri Lanka	
Kazakhstan	Lebanon	Nigeria	Vietnam	
Lithuania	Oman	Tunisia		
Romania	Qatar			
Serbia	UAE			
Slovenia				
Ukraine				

Source: MSCI



	Nominal GDP (US\$ in Trillions)*	GDP per capita (US\$)*	Population (millions)^	% of Population Under 30^
Frontiers	3.6	6,047	902	60.9%
Emerging Markets	24.5	9,638	3,995	52.2%
USA	17.4	54,610	319	42.1%
Japan	5.2	38,297	127	30.4%
World	76.9	12,972	7,033	53.9%

Source: Schroders

\*IMF and World Bank (estimates as of October 2013)

^UN World Population Prospects database (2010 estimates)

Around 13% of the world's population lives in these countries and the total nominal GDP in 2014 is estimated to be US\$ 3,595 bn or 4.7% of the world's nominal GDP. Compared to the rest of the world, the region (primarily Africa) appears to have a more attractive demographic profile than many of its emerging and developed counterparts, with more than 60% of the population under the age of 30.

### 3. Why are Frontier Markets Generating Interest Again?

#### 3.1 Strong economic growth

The proponents of frontier equity investing generally expect these economies to grow faster than emerging and developed economies and to eventually develop successfully as many of today's emerging markets have. However, it is important to note that research has shown little correlation between economic growth and equity market returns.

The following factors are expected to support robust economic growth from frontier markets:

- Favourable demographics;
- Low labour costs – as real wages in China and select South East Asian countries rise, Vietnam and Bangladesh have become the new low cost producers of Asia. Labour costs in Bangladesh are around a tenth of the costs in China;
- Demand for natural resources – the big four countries in the index (Kuwait, Qatar, UAE and Nigeria) are major exporters of oil and the region also has a substantial amount of gas reserves;
- Exposure to infrastructure spending – the Gulf states generally have stronger economic fundamentals, such as sound fiscal balances, low debt to GDP ratios and substantial foreign currency reserves. This provides them with opportunities to diversify their economies away from oil and gas and undertake large infrastructure projects.

#### Comparative Returns Periods to 31 March 2014 (in USD)

Index	1 Year	3 Years (%pa)	5 Years (%pa)	7 Years (%pa)	10 Years (%pa)
MSCI Frontier Index	25.5%	8.6%	15.3%	0.2%	7.9%
MSCI Emerging Markets Index	-1.1%	-2.5%	14.8%	3.7%	10.5%
MSCI World ex AU Index	18%	9.9%	16.6%	3.7%	7.6%

Source: eVestment Database, MSCI

#### Comparative Calendar Year Returns (in USD)

Index	2013	2012	2011	2010	2009	2008
MSCI Frontier Index	26.3%	9.2%	-18.4%	24.2%	11.7%	-54.1%
MSCI Emerging Markets Index	-2.3%	18.6%	-18.2%	19.2%	79%	-53.3%
MSCI World ex AU Index	28.3%	16.3%	-4.8%	12.2%	29.4%	-40%

Source: eVestment Database

Note: Returns are presented in USD to remove the impact of AUD/USD currency fluctuations.

#### 3.2 Diversification benefits

From a portfolio construction perspective, correlation analysis suggests that frontier markets have lower correlations with developed market equities and Australian equities than do emerging markets. It is also argued that intra-market correlations among frontier market countries are relatively low, resulting from the domestic-oriented nature of these economies.

#### 3.3 Recent strong performance

Another reason for more recent interest also appears to be the asset class's strong performance, which has come at a time when investors have been disappointed with emerging market returns.

Given the asset class's recent strong performance, it is not surprising that valuations have deteriorated such that frontier markets now appear to be more expensive than emerging markets at the aggregate index level. Nevertheless, frontier markets do display attractive fundamentals with higher earnings growth, higher Return on Equity (ROE) and lower leverage than both emerging and developed markets equities.

### 4. Risks and Challenges

While we agree there is potential in frontier markets, it is important to bear in mind that the total market capitalisation of the asset class is around USD 158B compared to emerging markets which has a market capitalisation of around USD 3.8 trn (MSCI Emerging Markets index) and global equities which has a market capitalisation of USD 32 trn (MSCI World ex Australia index). At around 0.5% of the global market capitalisation, it has very low capacity. To put things into perspective, the total market capitalisation of the MSCI Frontier Markets index (free float adjusted) approximately equates to the market capitalisation of BHP!

The MSCI Frontier Markets index was launched in 2007 and the total market capitalisation has remained low at less than 1% of the global market capitalisation since its inception seven years ago. By contrast, the total market capitalisation of the MSCI Emerging Markets index grew from 1% in 1988 to 8% of the global market capitalisation in 1995. While we are cognisant that the growth was supported by the addition of 17 countries to the index, there are few markets of equivalent size to Brazil, Russia, India and China in the frontier universe.

#### 4.1 Benchmark composition

The MSCI Frontier Markets index is quite concentrated with 63% of the index in the top

Benchmark Characteristics as at 31 March 2014	MSCI Frontier	MSCI Emerging	MSCI World ex AU
Average Market Cap			
- Weighted Average	\$9.6B	\$46B	\$97B
- Median	\$2.1B	\$5.8B	\$12.2B
Dividend Yield	3.4	2.6	2.3
P/E using FY1 Est	12.1	10.7	15.3
P/B	1.8	1.5	2.1
Historic 3 Yr EPS Growth	10.5	8.2	8.1
ROE	17.3	16.7	17.0
LT Debt/Capital	21.2	26.5	34.8

Source: Factset

four countries and almost 70% combined in the Financials and IT & Telcos sectors. Five out of the Top 10 stocks are in Financials and Gulf stocks dominate the top 10 index holdings.

Index composition will matter little to benchmark-unaware managers and in fact this concentration provides greater support for adopting benchmark-unaware managers. Nevertheless, index composition matters for index-based strategies and re-composition events can lead to periods of higher volatility for impacted stocks.

## 4.2 Lack of Liquidity

While liquidity varies across stocks, frontier market stocks are generally less liquid than emerging and developed markets stocks. The low trading volume generally impacts investors through wider bid-ask spreads and higher trading costs. The lack of liquidity means that it may be very difficult for investment managers to exit or trim the investment on short notice, should the underlying company fundamentals change dramatically.

Under normal conditions, managers may take from two days to three weeks to build a position and more time may be needed to exit. Emerging markets managers will typically adopt liquidity limits ranging from USD 1bn to USD 3bn of daily traded volume. Taking the more conservative end of the range (USD 3bn), less than 40 stocks in the index have sufficient liquidity. Some managers explicitly recognise this limited liquidity and we are aware of one manager that imposes a 12 month lock up on its frontier markets product.

The 2008 Financial Crisis was an example when liquidity (or lack thereof) had a significant impact on the asset class returns. As many institutional investors withdrew their investments in risky assets, the MSCI Frontier Market index (in USD) fell by 54% in Calendar Year 2008 even though most frontier economies were actually not impacted by the crisis.

Finally with the largest countries by market capitalisation being Qatar and the United Arab Emirates about to leave the frontier universe, the liquidity of the asset class will materially

diminish, squeezing capital into a smaller universe of stocks.

## 4.3 Macro-driven Markets – Resource rich, but export dependent?

The top four countries in the index (Kuwait, Qatar, UAE and Nigeria) are major exporters of oil and it is argued that as emerging economies such as China and India continue to grow, demand for natural resources generally increases. Several of today's emerging markets, such as Brazil, Indonesia and Russia, have been beneficiaries of this trend.

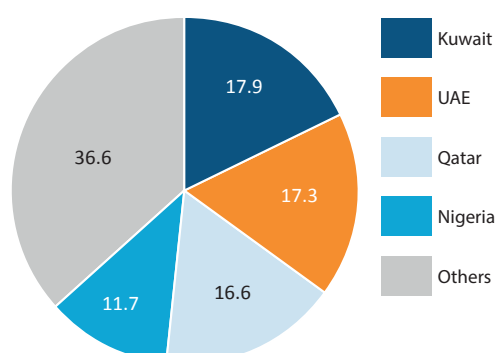
However, commodity exports are cyclical and commodity-driven economies without structural reform to decrease reliance on exports are likely to be vulnerable to fluctuations in global growth and capital flows. In addition, Australian investors generally have substantial allocations to Australian Equities, which already provides them with exposure to movement in commodity prices (primarily iron ore and coking coal).

## 4.4 Political, Social Instability and Regulatory Risks

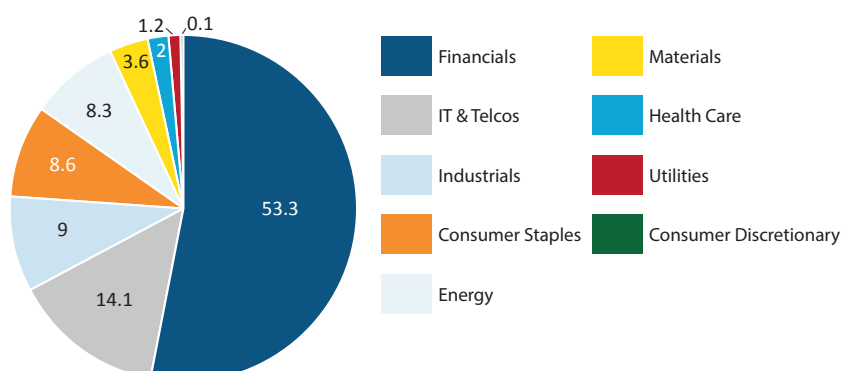
While most countries exhibit positive economic and demographic factors, they often have insufficient infrastructure and fragile economies. Some are frequently troubled with social and civil unrest and have non-democratic forms of government. Not long ago the Arab Spring impacted some countries across the Middle East and North Africa; it continues to impact Syria. The most recent event in Ukraine also highlights that political and social instability risks are a fact of life.

Other challenges for investors are often related to unreliable public data, inadequate accounting standards and lack of transparency.

Benchmark Country Exposure



Benchmark Sector Exposure



Source: Factset, JANA

Country	Transaction charge A\$	Safekeeping bps
<b>Frontier Markets</b>		
UAE	135	44
Kuwait	94	31
Nigeria	130	34
Argentina	90	20
Kenya	118	33
Oman	148	39
<b>Major Markets</b>		
Australia	13	0.7
US	14	0.8
China	99	16
Japan	23	1.5
UK	21	1.1

Source: JANA. Average costs were sourced from six custodians and they may vary depending on size of the assets in the market and transaction volumes.

Many of these markets are also known to suffer from high levels of corruption while at the same time, weak or non-existent property laws make enforcement of title a concern. These issues in particular make frontier markets a difficult proposition for investors with strict environmental, social and governance requirements.

#### 4.5 Custodian costs

Custody costs vary across countries. In general, custodial charges, such as transaction costs and safekeeping costs, are significantly higher for frontier mandates than emerging and developed markets. The table above compares the custodial charges in some frontier markets to major markets.

In addition, investors need to consider active management fees. We have seen fees range from 120 to 250 bps and may include performance fees.

## 5. Conclusion

The potential of frontier markets is significant, but so too are the risks. So too, are the practical impediments for institutional investors; a consideration that we believe warrants greater prominence in the debate than it receives.

The 'frontier opportunity' is, in reality, a very small subset of global equity securities with significantly limited liquidity. These markets are very inefficient, not entirely for all the right reasons, and investment costs can be very high. A long term investment horizon (at least seven years) is essential and lock-up periods may be a necessity to manage liquidity.

At this time, JANA does not believe that frontier investing is an opportunity that is practical for institutional clients to pursue as a segregated investment theme. Our recommendation at this time is to seek to participate in frontier markets via opportunistic investment within emerging markets portfolios. Hopefully this situation will change in the medium term as financial markets liberalise, become better regulated, deepen and offer greater liquidity.

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