Frontier Markets: An opportunity for growth and diversification

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Article Highlights

- Investors have shown an increasing interest in higher-yielding frontier markets, which are fast growing, but less developed and more volatile than the broader set of traditional emerging markets.

- Higher growth, improved policy making and better political stability have driven attractive returns for both frontier market stocks and bonds recently.

- Underpinning the economic activity in frontier markets are positive demographics, increasing urbanization, technological development, and an effort to bridge the large infrastructure deficit.

- While frontier markets have much in common, there are also significant differences in their political and policy environments, natural resources, economic structures and cycles.

- Frontier markets can be an added source of return potential and diversification for an Emerging Markets portfolio when combined with rigorous analysis, careful security selection, and appropriate sizing.

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Ten years ago, frontier markets — fast-growing countries but less economically developed than the broader set of emerging markets — were largely unexplored by investors. Political instability, very high inflation, large currency fluctuations, lack of fiscal discipline and institutional policy making, poor business climate and difficulties gaining access made investing in these areas too risky to justify. Few of their major corporations had shares traded on a public exchange, and those that did were often off-limits to foreigners. Similarly, there were few frontier countries that had issued government bonds in U.S. dollar markets or opened their local markets to foreign investors.

Over the past five years, however, investor interest in frontier markets — such as, Paraguay, Dominican Republic, Ecuador, Kenya, Nigeria and Vietnam — has been growing amid low interest rates in the developed world, slowing growth across many emerging markets, combined with better political stability and economic stewardship seen in frontier markets. With Brazil, Russia, India and China (the BRIC countries) and other traditional EM countries, such as South Africa, Turkey, Mexico and Indonesia dominating most emerging market
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Investors, should however, carefully consider their exposure and the approach taken to frontier market stocks and bonds due to high volatility and the risks related to weaker institutions, poor transparency and lack of buffers to external shocks.

Frontier markets have experienced faster growth

Many frontier market countries have faster-growing economies than developed markets or larger emerging markets, which have seen a downshift in growth. For example, growth in both Russia and Brazil is expected to be negative this year while others such as China, South Africa, Turkey and Colombia are expected to slow meaningfully. On the other hand, growth in several frontier markets, such as Dominican Republic, Kenya, Vietnam, Paraguay, Nigeria, among others is broadly expected to be considerably higher, ranging anywhere between 4.5-6.5% this year.

The economic buoyancy of frontier markets and search for higher yield has translated into solid returns recently for both stocks and bonds, especially when compared to the broader emerging markets universe. The MSCI Frontier Markets Investable Market Index (IMI), which has 349 constituents across 24 countries, posted a 6.42 percent gain in 2014, compared with a 1.72 percent decline for the MSCI Emerging Market IMI. Frontier Market stocks, as shown in Exhibit 1, have outpaced Emerging Market equities over the last few years.

Meanwhile, frontier market bonds, as represented by the J.P. Morgan Next Generation Markets Index (NEXGEM) index, which now includes 32 frontier countries, returned 10.5 percent, outperforming the 5.5 percent return for the more broadly followed J.P. Morgan EMBI Global Diversified benchmark index (where NEXGEM countries now represent close to 12% of the index) for emerging market bonds in 2014. Exhibit 2 shows the NEXGEM (Frontier Market bond index) and the EMBI Global Diversified index (Emerging Market bonds) “spreads” or yields above U.S. Treasury bonds with comparable maturities.¹

Exhibit 1

![Frontier and emerging market equity performance, 2011–2015](chart.png)

Source: Haver Analytics
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Exhibit 2

Frontier market bonds have performed well over the last few years

Past performance is no guarantee of future results.

A rising middle class

Underpinning the surging economic activity in frontier markets are growing populations that have the potential to form a new middle class and help foster the creation of a more developed economy. Of the 32 countries that NEXGEM classifies as frontier markets, seven are in the top 50 countries for population growth, according to 2013 World Bank statistics.

Population growth by country, 2013

Source: World Bank
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Frontier markets tend to have very young populations as well, providing a source of growing consumer demand, labor for local businesses, and an expanding tax base to fund infrastructure projects. In Nigeria, 44 percent of the population was 14 years old or younger as of 2013, while in Pakistan and Jordan 34 percent fell into that age bracket, according to World Bank data. That compares with 13 percent for Germany and Japan, 18 percent for the United Kingdom, and 20 percent for the United States.

These populations are becoming increasingly urban as well, attracted by the increased economic opportunities in cities compared with rural areas. In Bolivia, for example, the percentage of the population living in urban areas rose from 56 percent in 1990 to 68 percent in 2013. For the Dominican Republic, the urban population grew from 55 percent in 1990 to 70 percent in 2013.

As a result, in many frontier markets the service sector now represents a much larger part of the economy than what had previously been assumed and is increasingly an even bigger driver of growth. Services such as banking, IT, tourism etc. are growing rapidly, providing a boost to growth.

Improving macroeconomic policy management

Another reason why investors are warming up to frontier markets has been improved macroeconomic policy management and coordination between fiscal and monetary authorities. Additionally, in order to issue debt in US dollar markets, most of these governments have to bear the constant scrutiny of ratings agencies and investors which helped to improve transparency and increase data reporting frequency. Many frontier markets countries have also undergone positive structural reforms including reforming the power sector, which has been a key drag on both economic activity and cost of doing business. Others have reduced fuel subsidies, which have historically siphoned critical budget resources away from other needs. Most frontier economies have also improved their governance and ease of doing business with only a handful stalling or reversing recently. This helps frontier markets attract not only portfolio investments in the form of equities and bonds, but also long-term foreign direct investments and multilateral/bilateral loans that are crucial for growth.

Increasing political stability

There is increased political and economic stability overall in frontier market countries. Military in most frontier countries is now behind barracks and democracy, even if less robust than other developed countries, is increasingly the norm. A recent example is the Presidential election in Nigeria, which was remarkable given that a sitting incumbent lost — setting the stage for the first peaceful transfer of power from the ruling party PDP that had led since the country ended military rule in 1999.

Diversity along the frontier

Although frontier markets can have much in common in terms of their attractions, there are important differences in their political and economic situations, natural resources and infrastructure development — all critical issues for investors to pay attention to.
For example, Nigeria and Kenya are both African nations that have suffered terrorist attacks in recent years. However, their differences are much more significant than their similarities. Nigeria has a population of almost 200 million, compared with fewer than 45 million people in Kenya, and the Nigerian economy is almost 10 times the size of Kenya’s. About half of Nigeria’s population lives in urban areas, while less than one-quarter do so in Kenya. GDP per capita is much higher in Nigeria than in Kenya. Nigeria is a large oil producer and exporter, while Kenya’s economy is more diversified, focused on domestic manufacturing and tourism and to a lesser extent on agriculture/soft commodities. As a result, revenues from oil in Nigeria make up a hefty 75 percent of overall revenues, making it very vulnerable to a fall in oil prices. In the case of Kenya, on the other hand, domestically generated revenues through income and VAT taxes are what constitute the bulk of the revenues (around 80 percent), making it a lot more resilient economy.

These and many other structural and policy differences among various frontier markets, even those in relatively close proximity, call for a highly selective approach.

Frontier markets in your portfolio

With higher growth rates and increasing investability, exposure to frontier markets can offer a way to improve a portfolio’s diversification and enhance risk-adjusted returns, which take volatility into account. Because frontier markets are still relatively undeveloped economically, they are less influenced by global economic cycles than emerging or developed markets, and therefore their returns tend to reflect domestic more than international economic conditions. For the same reason, returns from one frontier market don’t usually track returns from others; economic trends influencing Sri Lanka, for example, tend to be quite different than those affecting the Ivory Coast or Paraguay.

An emerging markets equity or bond strategy that incorporates a rigorous bottom-up fundamental analysis, careful security selection, and appropriate position sizing of its frontier markets exposure, can add compelling sources of higher risk-adjusted return potential and diversification to a portfolio.

To learn more about how frontier markets can help diversify an emerging-market bond or stock portfolio, talk to your TIAA-CREF advisor.
Of course, Frontier and Emerging market bonds and related investments are not guaranteed and carry much greater risk than a U.S. Treasury bond including risk of loss of principal.

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Please note that equity and fixed income investing involve risk.

Diversification is a technique to help reduce risk. There is no guarantee that diversification will protect against a loss.

Funds that invest in foreign securities are subject to special risks, including currency fluctuation and political and economic instability.

The definition of countries and the number of countries included in equity and bond indices that are classified as frontier differ.

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