Market & Investment Insights

Frontier Markets: An opportunity for growth and diversification

Anupam Damani, Portfolio Manager, TIAA-CREF Emerging Markets Debt Fund; and Alexander Muromcew, Portfolio Manager, TIAA-CREF Emerging Markets Equity Fund

Article Highlights:

- Investors have shown an increased interest in frontier-market stocks and bonds, which have shown compelling yield, return, and diversification benefits in recent years.
- Higher growth, improved policy making, and better political stability have been driving attractive returns in these markets.
- Underpinning the economic activity in frontier markets are positive demographics, increasing urbanization, hard and soft commodities, technological development, and an effort to bridge the large infrastructure deficit.
- While frontier markets have much in common, there are also significant differences when it comes to their political and policy environments, natural resource base, economic structures and cycles.
- Frontier markets can be an added source of return and diversification for an Emerging Markets portfolio when combined with rigorous analysis, careful security selection, and appropriate sizing, however, risks must be carefully weighed, because these markets can be volatile and illiquid at times.

Ten years ago, frontier markets were largely unexplored and mostly unavailable to investors. Political instability, very high inflation, lack of infrastructure and limited access made investing in these areas too risky for most. Few of their major corporations had shares traded on a public exchange, and those that did were often off-limits to foreigners. The sovereign bond issues in existence were illiquid, difficult to value, and denominated in volatile local currencies.

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 in frontier countries and improving economic stewardship 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 portfolios, investing in higher yielding and less correlated frontier markets

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offers a compelling way to improve a portfolio's diversification, while also providing another potential source of attractive risk-adjusted returns.

Growing interest in frontier-market stocks and bonds

Frontier markets are a relatively new and small corner of the financial universe. Definitions of "frontier market" vary, but generally these markets are characterized as smaller and less mature than emerging markets, yet still accessible to foreign investment. On the equity side, MSCI, an index provider, currently classifies 24 nations as frontier markets, and its MSCI Frontier Markets Index includes 127 constituents with a total market capitalization of $92.8 billion. U.S. mutual fund and ETF investors have invested about $4.4 billion in frontier-market equities since 2010; that is a small number for the industry, but considering the first retail funds in the space launched about a decade ago, this growth has attracted attention. The MSCI Emerging Markets Index, by comparison, includes 833 constituents and has a market capitalization of $4 trillion. U.S. retail fund investors have put about $72.7 billion to work in these markets since 2010.[1]

Fixed-income investors are also finding more opportunities in frontier markets. According to Thomson Reuters data, in 2014 frontier markets issued $19.7 billion in hard-currency debt (local bonds issued in dollars, euro, or yen)—an almost 50% rise from 2013 and nearly three times the 2012 level. This represents nearly one-fifth of the more than $100 billion in hard-currency bonds issued by emerging markets overall. Many frontier-market debt issues were heavily oversubscribed; when the Ivory Coast sold $750 million in 10-year notes yielding 5.623% in July 2014, investors placed orders worth $5 billion. Ethiopia's sale of $1 billion 10-year notes yielding 6.63% in December 2014 drew bids worth $2.6 billion.

Improving macroeconomic policy management

Investors have been warming up to frontier markets for many reasons, including 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

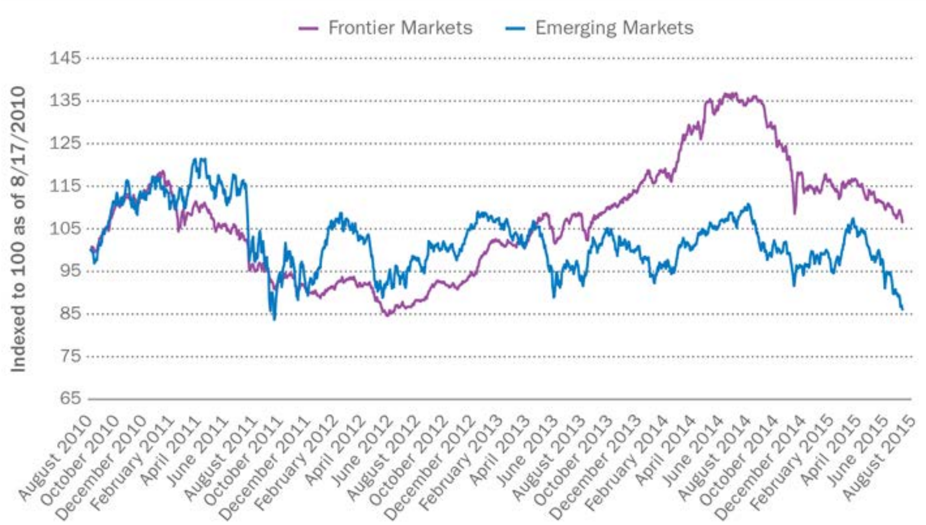
It is not only economic improvement, but politically—as well, there is increased stability overall. Military in most frontier countries is now behind barracks and democracy, even if less robust than other developed countries, is increasingly the norm. A recent example is the Presidential election in 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.

Attractive returns and favorable equity correlations, though risks remain

Recently, the economic buoyancy of frontier markets has translated into compelling returns for equity and bond investors (see Exhibits 1 and 2). The MSCI Frontier Markets IMI posted a 6.42% gain in 2014, compared with a 1.72% decline for the MSCI Emerging Markets IMI. Meanwhile, frontier-market bonds, as represented by J.P. Morgan's Next Generation Markets Index (NEXGEM), which has now 32 frontier countries, returned 10.5%, outperforming the 5.5% return for the more followed J.P. Morgan EMBI Global Diversified benchmark index (where NEXGEM countries now represent close to 12% of the index for emerging-market bonds.

Exhibit 1

Frontier and emerging market equity performance 2010–2015



Source: MSCI Inc., data as of 8/18/15
It is not possible to invest in an index. Performance for indices does not reflect investment fees or transactions costs.

Frontier Market equity correlations versus developed markets have been lower than Emerging Markets versus developed markets in all time periods, making a good case to add securities from this asset class. Correlations for Frontier Markets versus U.S., Europe and Emerging Markets have been declining notably over the past three years, suggesting greater divergence of returns from the other markets and thus increased diversification potential (see Exhibit 2).

Exhibit 2

Frontier stocks correlation with other asset classes

1 yr ended 12/31/14	S&P 500	EM Stocks	European Stocks	Frontier Market Stocks
S&P 500	1			
EM Stocks	0.71	1		
European Stocks	0.76	0.56	1	
Frontier Market Stocks	**-0.04**	**0.33**	**0.35**	**1**

Frontier market bonds correlation with other asset classes

1 yr ended 12/31/14	High Yield	U.S. Treasury Bonds	S&P 500	Frontier Market Bonds
High Yield	1			
U.S. Treasury Bonds	-0.21	1		
S&P 500	0.73	-0.27	1	
Frontier Market Bonds	**0.84**	**-0.04**	**0.58**	**1**

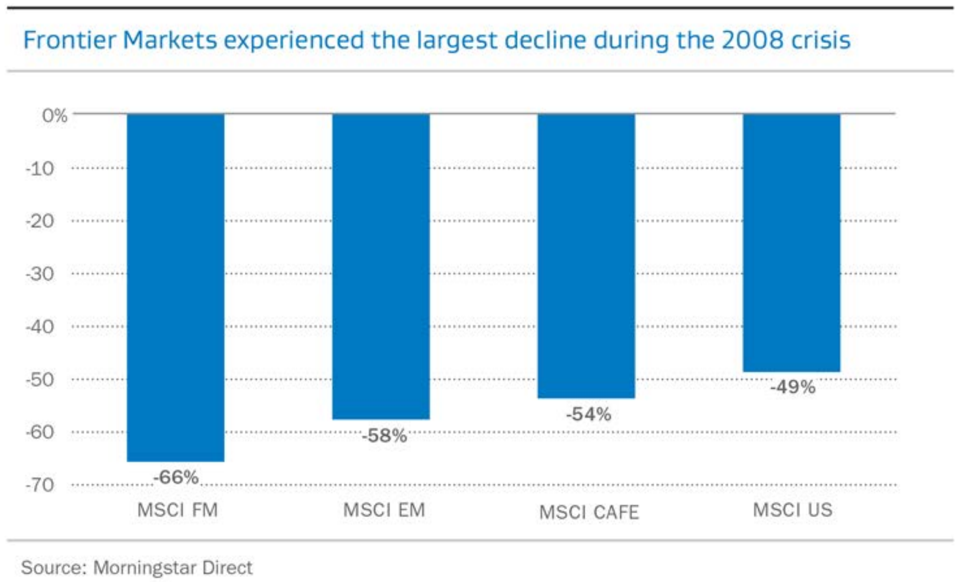
Source: JP Morgan, Morningstar.
Correlation ranges between -1 and +1, perfect positive correlation (+1) means two securities or asset classes move in lockstep in the same direction, while perfectly negatively correlated securities/asset classes (-1) move in opposite directions. Correlation of 0 means movements of the securities have no correlation, and are random.

Risks also need to be understood

While frontier markets have performed well in recent years, investors should understand the myriad risks involved, which are often amplified compared to other markets. Terrorist attacks, military coups, currency volatility and developing regulatory infrastructure are just some of the risks that investors face.

Frontier market securities also may become highly illiquid during periods of volatility, making it difficult for investors to sell when needed. This was evident during the 2008 financial crisis; frontier-market equities experienced a lower “bottom” (-66%) than the U.S., Europe and emerging markets (see Exhibit 3).

Exhibit 3



Young, expanding populations create growth

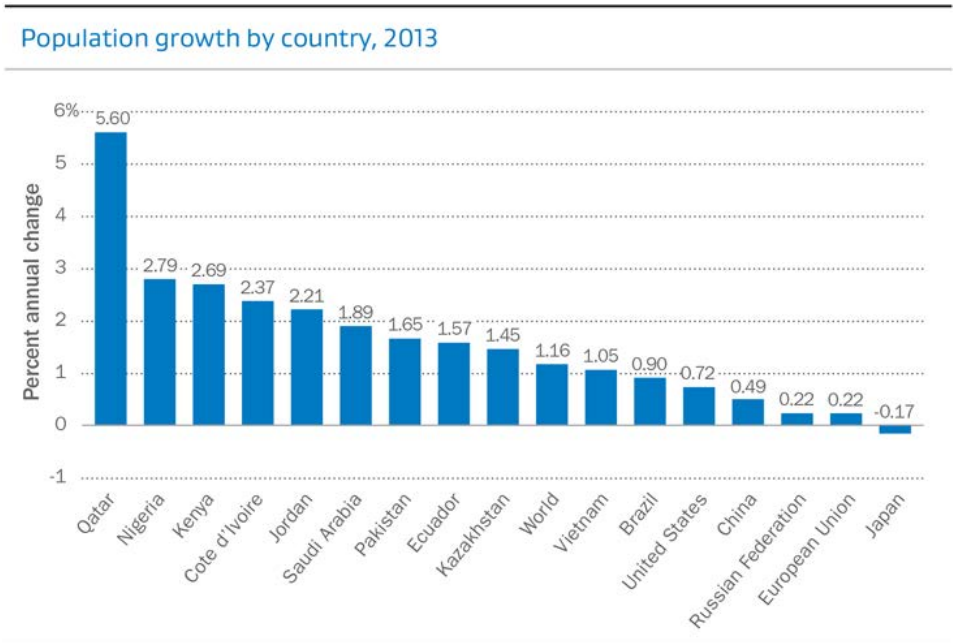
While sometimes volatile with a high degree of risk, there are many positive trends taking shape in frontier markets, including population growth, demographics, and improving economic vibrancy and stability in many countries.

By comparison, some BRIC countries have seen a downshift in growth. For example, while the International Monetary Fund (IMF) expects Brazil's gross domestic product (GDP) to grow by a mere 1.4% in 2015, neighboring Peru is expected to see 5.1% growth. Russia, hurt by the drop in the price of oil and international sanctions due to its involvement in Ukraine, may just escape recession in 2015 with 0.5% growth. Meanwhile, a former Soviet Republic, Uzbekistan, is predicted to grow 6.5%.

Underpinning the economic activity in frontier markets are young, growing populations entering their peak working years, and an urban migration that has historically presaged improved standards of living, greater consumption, and economic growth. Of the 24 countries that MSCI classifies as frontier markets, seven placed in the top 50 countries for population growth, according to 2013 World Bank statistics. In contrast, just one of the 23 nations the MSCI classifies as emerging markets—Qatar—makes the top 50 list.

Not surprisingly, these growing countries have a large percentage of young people. In Nigeria, 44% of the population was 14 years old or younger as of 2013, while in Pakistan and Jordan 34% fell into that age bracket, according to World Bank data. That compares with 13% for Germany and Japan, 18% for the United Kingdom, and 20% for the United States.

Exhibit 4



Source: World Bank

Economically, some key risks are also receding in frontier markets. Better economic management and coordination with monetary policymakers have brought inflation down in many countries. Costa Rica, Ecuador, and Kazakhstan had double-digit inflation rates as recently as 2000, but those rates are all now 6% or lower. In Sri Lanka, the economy is benefiting from a "peace dividend" after a 25-year civil war ended in 2009. Since that time, the country's local stock market has grown five-fold in capitalization, from $3.7 billion before the war ended to $24 billion.

Diversity along the frontier

Although frontier markets have some common traits, there are significant differences in their individual political and economic systems, access to natural resources, and progress on infrastructure development. For these reasons, 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.

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, Nigeria's oil revenues make up a hefty 75 percent of the total, making it vulnerable to a fall in 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 far more resilient economy.

These and other differences among frontier markets, even those in relatively close proximity, call for a highly selective approach. For instance, many but not all frontier markets are large exporters of natural resources such as oil. Nigeria, Angola, Kuwait and Kazakhstan are major oil exporters, while Pakistan, Kenya, Jordan and Jamaica are energy importers. From an investment perspective, it generally makes sense to invest in oil-exporting nations when oil prices are strong or rising, and in oil importers when oil prices are weak or falling.

The Frontier future

We consider frontier markets a deepening and extension of emerging markets. An investment strategy that incorporates frontier markets, using rigorous, bottom-up fundamental analysis and paying careful attention to the countries' political stability and policy frameworks, has the potential to add risk-adjusted returns and diversification to a portfolio. Although future performance can never be guaranteed, frontier markets, if added selectively, can add value to a portfolio through diversification and exposure to stronger growth potential and higher yield.

To learn more about how frontier markets can help diversify an emerging-market stock or bond strategy, talk to your TIAA-CREF advisor, contact your TIAA-CREF representative, call 888-842-5433, and press 2, or visit the Financial Advisor website.

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[1] Morningstar data, open-end mutual funds and exchange-traded fund flows are estimated, period covers January 1, 2010- April 30, 2015.