
ANNUAL REVIEW AND FORECAST 2013

INVESTMENT

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Benefits and Pensions
monitor

The Canadian Magazine Of Employee Pension Fund Investment And Benefits Plan Management

December 2013 Issue

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The Case For Frontier Markets

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One of the major issues facing investors today, whether they are individuals or institutions like pension funds and not-for-profits, is finding investments that are not correlated with each other. The traditional formula for constructing a balanced portfolio – which involves holding varying proportions of cash, fixed income, and equities – was based on their different characteristics and the reduction in overall volatility that these produced.

Thus cash had zero volatility, provided capital preservation in nominal terms, and offered some income. However, it also offered generally low returns. Fixed income produced higher income and the eventual return of your initial investment in nominal terms, but was sensitive to the direction of interest rates. Equities were the most volatile, but offered the potential for growth in both capital and income in real terms. By combining these different asset classes in varying proportions, investors could come up with a portfolio that offered them the desirable features of each category while offsetting some of the attendant volatility, owing to their lack of correlation with each other.

Essentially Variations

The addition of other asset classes such as private equity, infrastructure, forestry, and real estate as well as abso-

lute return-oriented portfolios such as hedge funds are essentially variations on the basic theme of attempting to combine non-correlated assets to produce an acceptable mixture of return and volatility. Each of these newer asset classes usually brings with it a corresponding increase in fees and reduction in liquidity compared with the original assets.

The desire to find alternatives is understandable, particularly in recent years, as the decline in interest rates to 60-year lows has brought about an erosion of the advantages of the traditional balanced portfolio. The nominal yield on cash has become minuscule, producing a negative real return in real inflation-adjusted terms. Similarly, yields on investment grade government bonds have fallen to levels that produce little income to offset their vulnerability to changes in interest rates.

There is also the very high probability that investors will suffer erosion of their original capital in real inflation-adjusted terms once long-term yields begin to increase as has happened over the last six months. Bull and bear bond markets tend to last for a generation or even longer. Interest rates in the U.S. and Canada fell between 1920 and 1946 and then rising up until 1981, which marks the start of a bull market that has now lasted for 32 years. If the yields of 1.5 per cent on the 10-year U.S. Treasury bond reached in 2012/13 mark the lows for this cycle, investors face the unwelcome prospect of bonds once again becoming ‘certificates of confiscation’ as they were known in the 1970s.

Meanwhile, the increasing correlation of developed equity markets, dominated by computer driven trading systems that have reduced the average holding period of stocks to less than six months (from the over six years that was common 30 years ago) has resulted in the equity indices becoming more volatile in terms of their standard deviation and trading at valuation levels that are high on long-term measures such as cyclically adjusted price earnings to GDP. This has made it harder for active managers to add value and led to a move towards indexation using market capitalization weighted indices, which reinforce volatility and high valuations.

Traditional Categories

Lastly even asset classes that used to be less correlated with the traditional categories of investment grade government and corporate fixed income and developed market equities, such as high yield (junk) bonds and emerging market equities, have become more highly correlated. The correlation of the MSCI Emerging Markets Index with the MSCI World Index has risen from under 0.5 in 2000 to over 0.9 today as the emerging markets have developed and become more globalized. Meanwhile, the fall in interest rate spreads of high yield bonds over investment grade bonds from over 10 per cent in 2008 to under four per cent today has sharply increased their correlation, as there is no longer a large income buffer to reduce their sensitivity to interest rate moves.

In looking for non-correlated asset classes, investors should consider examining adding frontier markets to their equity portfolio. Frontier markets are generally considered to be the less developed emerging markets, with lower levels of GDP per capita and less developed and liquid capital markets. They include Vietnam, Nigeria, Kenya, Bangladesh, Romania, Kazakhstan, Morocco, and Colombia. Many observers believe these economies are at the same stage of economic development as the major emerging markets such as China, India and Brazil were 15 to 20 years ago. They may also be countries with restrictions on foreign investment, such as Saudi Arabia and Iran, or which have been downgraded as a result of misguided economic policies, such as Argentina and Venezuela.

The correlation of the MSCI Frontier Markets Index with the MSCI World Index has been below 0.3 for most of the last decade, with a spike to 0.6 during the financial crisis in 2008/09. Since then, their correlation has returned to levels below 0.3. Interestingly, frontier markets are not particularly correlated with emerging markets either, with the correlation between the MSCI Frontier and Emerging Markets remaining below 0.4 for the same period. While individual frontier markets are volatile, they are also not correlated with each other – what happens in Estonia has little relation to events in Lebanon or to developments in Sri Lanka.

Given their relatively illiquid and inefficient capital markets and the heavy weighting of the small, but wealthy, Gulf states such as Qatar, Kuwait and the United Arab Emirates (UAE), frontier markets are an area where active management has consistently added value, with almost all of the frontier market funds with track records of three or more years having outperformed the MSCI Frontier Markets Index, despite having management fees of more than two per cent per annum.

One approach is to use an actively managed global frontier markets equity fund as the means of gaining access. Global frontier market Exchange Traded Funds (ETFs) have management fees of 0.7 per cent or more and are heavily weighted in the wealthy Gulf states of Kuwait, Qatar, and the UAE, or else dominated by Latin American ADRs (American depository

receipts). Investors choosing regional ETFs and funds such as African, Eastern European, or Middle Eastern funds run the risk of being in an area that has unfavourable demographics, political instability, or persistent problems in terms of political or corporate governance.

The conclusion that my co-author Al Emid, news director/producer at Emerging and Frontier Markets Investing, and I reached in our recently released book, 'Investing in Frontier Markets; Opportunity, Risk and Role in an Investment Portfolio' (Wiley & Co.), was that all equity investors should have at least a small portion of their international equity portfolio in frontier markets, perhaps five to 10 per cent of their international equity portfolio. This could be done by utilizing some of their emerging markets allocation which would lower the overall volatility, given the low cor-

relation between emerging and frontier markets, as well as between frontier and developed markets.

Reducing Volatility

Even if frontier markets do not match the performance of emerging markets by doubling over the next decade, as the emerging markets have done over the last decade, their non-correlation should be valuable to investors in reducing the overall volatility of the traditional balanced portfolio.

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