INVESTMENT

Hidden tigers

Frontier markets may be more volatile than emerging markets, but there are some rising stars that may have the same potential as the ASEAN Tigers

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Frontier markets, by nature, are thornier and harder to evaluate than their emerging and developed counterparts. However, as the credit cycle nears its end and interest rates continue to hover in negative territory, they have the potential to generate the much-needed returns over the long term. Unearthing the next stars though requires patience and careful selection.

All shapes and sizes

One of the problems is this heterogenous group is difficult to define. From an MSCI perspective, which has emerging and frontier market indices, the focus is on size, liquidity and market accessibility when determining inclusion. MSCI executive director of index research, Pavlo Taranenko, points out: "We apply less stringent criteria for frontier because they typically tend to be less liquid. Companies may have lower free float than both emerging and developed markets and access may not be as easy. The markets are generally quite small, but some may offer additional diversification because they behave differently and may be less correlated with the rest of the world."

While these measures are also used by fund managers, Ashmore frontier markets portfolio manager, Andrew Brudenell, believes there should be greater emphasis on the institutional structural changes that are needed to address the typical challenges facing many frontier markets. These range from poor monetary or fiscal policy to lack of adequate capital market regulation as well as infrastructure.

"There not only needs to be a sensible economic policy but also financial, legal and capital markets frameworks," he adds. "The good news is that there are structural changes accelerating in several frontier economies, which could drive higher growth as well as boost stock market returns and provide attractive investment opportunities. It is important to remember though that these countries are like emerging market countries were 20 to 30 years ago. They are works in progress so there are bound to be wobbles. There will be no straight line to glory."

The past two years are a good example, growth was lacklustre in 2019, but if the International Monetary Fund forecasts are anything to go by, the emerging markets, and their frontier cohorts, will be the engines of the global economy. Together, they are expected to generate a growth rate of 4.6 per cent, up from 3.9 per cent last year, while developed markets remain flat at 1.7 per cent.

This perhaps explains why BlackRock Frontiers Investment Trust co-manager, Emily Fletcher, feels there is significant value in the smaller emerging and frontier markets with a number of these countries set up for a strong year in 2020. "We see the markets well supported by the lower rate environment and improved local and global liquidity," she adds. "Despite offering exposure to countries that we believe have high structural growth, equity markets across small emerging and frontier countries have not witnessed the same rally as bond markets over the last couple of years and hence look very attractively valued."

Fletcher also thinks that the asset class should get a boost from foreign exchange and that many developing country currencies look to have broken out towards year-end. "We note that a lot of stocks in our universe are trading at extreme low valuations despite generating strong free cash flow, resulting in very attractive dividend yields," she says.

Gaining access

In terms of access, there are a handful of exchange-traded funds but many market participants advocate an active approach because of the complexities and opaqueness of frontier markets. "The research quality is low and coverage of companies is poor, so you have to do your own homework," Carmignac head of emerging equities, Xavier Hovasse, says, who is an advocate of the blended approach. "You need to also look at cashflow, balance sheet and meet with the management."

Concerns over passively benchmarking against the MSCI frontier and emerging market indices are due to composition and whether they are a fair reflection of the asset class. As Brudenell points out, although some countries such as Argentina, Pakistan and Egypt may have been promoted to the ranks of the MSCI emerging market index, they are part of the Ashmore frontier investable universe because they still share many of the same characteristics and organisational problems of those countries. "It is a relative scale and they are still a work in progress but we do not believe they belong to the core emerging market index," he adds.

RWC co-head of emerging and frontier markets, James Johnstone, echoes these sentiments. He believes that the high growth opportunities in the frontier as well as the emerging market space are under-represented by current indices and funds. "What you are really looking for are the new ASEAN (Association of Southeast Asian Nations) Tigers (currently Hong Kong, Singapore, South Korea and Taiwan)," he adds. "This means countries with lower manufacturing costs and wages that can rise up the value chain generating consumer demand. For example, we like Bangladesh because it is now the second largest garment manufacturer, as jobs have moved from China and growth rates are around 7 per cent to 8 per cent."

Egypt is also on the investment radar with Fletcher noting "it is one of the more promising countries within our universe on a purely macro basis". The country has been described by the team as "the IMF poster child for structural reform". She notes that the fiscal deficit has been closed and the current account deficit has significantly reduced over the last couple of years thanks to a boom in tourism and energy exports - the country has neutralised its energy deficit.

"Interest rate cuts are expected to continue, which should boost economic activity, resulting in our preference for more cyclically sensitive sectors as we expect activity to pick up," she adds.

Fletcher also favours the Philippines because of its strong growth prospects as well as Vietnam, which is a popular destination for many frontier fund managers. However, the tight 25 per cent foreign ownership cap on companies can prove challenging for investors.

Neighbouring countries such as Thailand and Malaysia also have limits but they have circumvented this issue with nonvoting depositary receipts that help boost the liquidity. Although Vietnam is expected to follow suit, there is no definitive timeline.

As a result, fund managers seek certain pockets of opportunity. "Vietnam ticks all the boxes in terms of political and social stability, formation of a middle class, youth demographics and strong foreign domestic investment, Dragon Capital CIO, Bill Stoops, says. "It is more fundamentally sound than many emerging market countries but it is less liquid. The sectors that we think are the most attractive are retail, urbanisation and infrastructure, financial services – selective banks – and pharmaceuticals."

Favoured industries

In general, banks and retail – the bricks and mortar variety – are considered to be among the most attractive propositions on the back of accelerating domestic consumption growth. "It is a simple story in that 30 years ago, formal retail accounted for 5 per cent but now it has grown to 50-60 per cent in more developed Asian countries like Korea and Taiwan," Fiera Capital CIO (European division) and senior portfolio manager, Dominic Bokor-Ingram, says. "In Vietnam today, for example, formal retail is at 5 per cent so we have a clear precedent for the growth opportunity. Banks will also benefit from the increase in consumer lending opportunities in a growing formal retail market."

As for those countries to avoid, Malaysia and Kuwait are two on Fletcher's list. She notes that even though the Malaysian market continues to see extremely muted earnings growth, valuations are not particularly cheap. At the macro level, despite benign inflation, the central bank has not cut rates to incentivise growth, while the potential for fiscal stimulus remains constrained by already high levels of government debt to GDP.

Kuwait, on the other hand, is a more technical decision and is tied to the country being upgraded to emerging market status. "As we have noted during previous upgrades (Saudi Arabia, Qatar, UAE), domestic euphoria tends to drive the market into unsupported valuations," Fletcher says. "We are happy to take advantage of this market strength to take profits and redeploy risk to other areas of the portfolio." ■