

# Russell Research

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## Compelling and diverse return opportunities

A new frontier of market development brings exciting opportunities reminiscent of those offered by emerging markets during much of the 1980s and 1990s. These fledgling emerging markets have a relatively low correlation with global peers, offer high growth potential and, currently, attractively low valuations relative to mainstream emerging counterparts. The very nature of these frontier markets means that they are inefficient, offering skilled managers plenty of opportunities to generate high alpha.

### Untapped economic potential

As the 20th century drew to a close, emerging markets such as Brazil and China were the new frontier of investing. Now more mainstream, these markets contain some of the largest companies in the world and have become more integrated with developed world economies. As an example, Brazilian iron ore miner Companhia Vale do Rio Doce (Vale) was created by the state in 1942. Built initially to satisfy domestic demand, Vale had become the world's largest exporter of iron ore by 1975. The company was privatized in 1997 and began diversifying its product portfolio. Today it employs more than 100,000 people, has a presence on five continents and is the world's second largest miner by market value. A similar story has emerged among global financials, where by 2009 China and Brazil accounted for seven of the world's top 20 financial institutions by market capitalisation. A decade prior to that, emerging market institutions were notable by their absence.

Frontier markets, which are typically perceived as higher risk, are smaller, more diverse, populous and growing rapidly. These markets have evolved to offer access to the kind of investment opportunities that their emerging counterparts did 20 or 30 years ago. Frontier, or "pre-emerging", markets have an untapped economic potential that we believe is very compelling as a long-term investment opportunity.

These markets were until recently characterised by limited market accessibility, small company size and low liquidity. Those characteristics remain to some degree, but conditions have eased and markets have now become more investable, with lower restrictions on foreign investment and improved liquidity. This greater accessibility has

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heralded increased foreign capital and more direct investment in infrastructure or industrial production, thus stimulating economic growth. Financial systems in these markets remain under-leveraged in comparison to more developed peers, with low loan penetration. Meanwhile, strong urbanisation trends will offer opportunities for future credit growth and upside for economic growth.

### A compelling case for frontier investing

As an example, Nigeria - a member of OPEC - is one of the key frontier markets. The country possesses sizeable oil reserves, the world's 10th largest, according to the CIA. However, its emergence as an attractive market for investment had been held back by oil pipeline vandalism and militant takeovers of facilities in the main oil-producing region, the Niger Delta. Lately however, the Delta has stabilised, and the country - formerly a military dictatorship - has had several democratic transitions.

This combination of resource wealth and increasing macroeconomic/political stability is one of the key draws for investors. Many, but not all, so-called frontier countries are richly endowed with commodities. As one would expect from economies on four continents, there is great diversity. Kazakhstan, for example, unearths oil and natural gas, metals and minerals, while Argentina sells soybeans, corn and wheat. Meanwhile, Vietnam - increasingly an outsourcing destination for China - excels at manufacturing. In Africa, Ghana is the world's second-biggest cocoa grower after the Ivory Coast and is also the continent's second-largest gold producer after South Africa. Because of this diversity, and low levels of foreign ownership, stocks tend not to move in line with developed and emerging peers, in fact, they even tend not to track one another. For example, Eastern European markets will typically trade in line with each other, and will perhaps be more in line with developed regional peers, but they will trade very differently from the African and Frontier Asian countries.

Most of these frontier countries have a strong financial position, free of the debt burden borne by the developed world. Their populations are typically younger and growing more aspirational, with an ever greater access to information. As it did with the "Asian tiger" economies, this "demographic dividend" should herald a virtuous circle of increased demand and consumption, more employment and ultimately increased economic growth. According to Reuters, analysts have suggested that of the world's 20 most populous countries, only three are developed markets. Of the remaining 17, seven cannot yet be classified as emerging. Between them, Pakistan, Nigeria, Ethiopia, the Democratic Republic of Congo, Bangladesh, Vietnam and Iran have 750 million people ready at different stages to create demand and ultimately, economic growth.

We outline below the key benefits of holding an allocation to frontier markets in a diverse portfolio:

- **Frontier markets have a lower correlation with developed markets.** Many established, raw material-rich emerging markets have become more correlated with developed markets as the access to natural resources has diminished in the latter. Frontier markets have, on the other hand, traditionally been fuelled by local demand, but the globalisation of trade is creating real and multi-dimensional growth across the broader emerging markets asset class.
- **Potential source of higher alpha.** Managers with specific skills in these markets have a strong opportunity to generate high returns. Sell-side analyst coverage is frequently low at best, more often still at a development stage. Therefore, any managers that have dedicated resources to fundamental research in these areas could have a significant informational advantage, particularly those that have lengthy experience investing in

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emerging markets. Since there are higher barriers to entry into non-developed markets, these managers may be able to retain their advantages for some time.

- **Broadening investment opportunities - Countries.** Frontier markets broaden out the opportunity set of equity investing by offering access to countries in the earlier stages of market development. Strategically diversifying into these markets could help those investors looking for opportunities beyond core emerging countries.
- **Broadening investment opportunities - Market-cap.** A consequence of the growth of emerging markets has been that many investors have lost a significant percentage of their small-cap emerging markets allocations. Frontier markets companies tend to be smaller than their emerging peers.
- **Frontier markets present new opportunities.** The strength in frontier markets, the evolution of their capital structures and growing equity culture has increased the depth in stock markets, market liquidity, and the opportunity set for active stock selection processes. The acceleration in the development of these economies continues to provide not only richer universe representation but also attractive new markets for investors. Frontier markets offer the potential of an early mover advantage in building portfolio exposure.

#### Why now?

- The “early mover advantage” we describe above is, as its name suggests, transitory. **Interest levels** in these markets are growing rapidly, while high quality **manager capacity** is acutely limited. Meanwhile, **valuations** in these markets are currently very attractive relative to mainstream markets.
- The return opportunity will inevitably diminish over time, as markets develop and investor participation rises.

#### Investing considerations

- **Long-term investor (7-10 years).** Investing in frontier markets requires a longer-term outlook than core emerging markets due to potential liquidity issues, shorter-term volatility and the unpredictability of timing individual market development. These markets offer return potential, but investors need to be committed to a longer-investing time frame than may be the case for traditional emerging markets.

#### Investing Risks

Frontier market investments are typically perceived as being of higher risk than developed or emerging peers, given certain structural factors. These factors make frontier markets more vulnerable to sovereign, geopolitical, structural and inflation risks.

##### Sovereign/geopolitical risk

- Political systems are not always stable or fully democratic.
- Potential risk in rising protectionism and capital control.
- Financial and banking systems are often in the early stages of development, while the reliance on natural resources presents a greater risk in certain economic conditions.

##### Structural risk

- Returns can be more volatile and price movements more extreme.

*“Russell’s dedicated research analysts know the managers and their processes, they have watched these markets develop, and as a result, have refined our processes over time.”*

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- Markets can have differing levels of accessibility, for example, some operate with more stringent controls on entry and exit or on foreign ownership.
  - Low liquidity levels can make entering and exiting positions challenging, with larger investors forced to adopt a “slow in, slow out” approach, which does not always sit well with the inherent volatility of these markets and their potential for more extreme price movements. Liquidity rises sharply when sentiment is strong, but evaporates equally quickly as the mood sours, making the timing of any decision on buying or selling an asset difficult.
  - The costs of investing are high and transparency is low. Trading infrastructure may be inadequate, while markets are less transparent, with high custody costs.
  - Frontier market indices often therefore list the most-liquid stocks in what are thinly-traded markets, meaning investors could hold concentrated positions in sectors or countries.

#### **Inflation risk**

- Given the occasionally fragile nature of some of these frontier economies, governments may not have the necessary fiscal or monetary tools needed to rein in inflation.

#### **Conclusion**

Frontier market development offers exciting opportunities reminiscent of those offered by emerging markets. The growing strength in frontier markets has increased the depth in stock markets, market liquidity, and the opportunity set for active stock selection processes. The development of these economies continues to provide not only richer universe representation, but also offers skilled managers significant alpha potential.

#### **Research note**

Russell's research suggests there is a need for a more robust set of niche indexes in this exciting and developing marketplace, as investors increasingly evaluate frontier markets as a unique asset class for asset allocation purposes. With that in mind, Russell Indexes is launching the Russell Frontier Index™ in October. We believe that this Index offers a broader coverage of the active opportunity set in frontier markets than its peers.

As an example, the Index will include approximately 41 countries, and includes more African countries than its competitors. The Index has also been designed in such a way as to ensure that weights are adequately distributed across its constituent countries, which has been a criticism of the major competitors that already provide products in the frontier space. In contrast to some of its peers, it has no capitalisation restrictions on individual stocks.

The Index will represent 98% of the cumulative, liquid market capitalisation of frontier countries, and will offer exposures to more countries and more stocks than any of its major competitors, making it an ideal market proxy.

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**For more information about Russell Indexes call us or visit [www.russell.com/indexes](http://www.russell.com/indexes).  
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