Frontier Market Investing - Does It Make Sense?

In 1893, historian Frederick Jackson Turner gave a talk to the American Historical Society stressing the image of the frontier as defining the American ideal. That edge of growth, the frontier, which kept moving westward across the American continent, has, with today's global economy, spread right across the world.

When investing your hard-earned money, you have many different options when it comes to choosing the countries of the world in which to invest. Of those options, frontier markets may be the riskiest, but could they be worth it?

When it comes to investing, countries are divided into three main economic categories:

1. Developed Markets (including the U.S., Japan, and the European Union).
2. Emerging Markets (such as China, India, and Brazil), and
3. Frontier Markets (including Kenya, Jordan, and Vietnam).

Just like all that time ago in America, the frontiers have promise.

However, in order to grow from small shoots and prosper into a complete flower, frontier markets need to overcome serious problems like systemic corruption, poor corporate governance, and a lack of natural resources, among many other challenges in order to prosper.

Frontier markets, poor yet ambitious, are a volatile lot and some investors try to exploit this heightened risk with the aim of achieving better-than-average returns. However, frontier markets can quickly plummet over a day or two, thanks to government coups, natural disasters, or terrorist attacks, destroying any well-thought-out investment strategy.

How Many Nations Are Considered Frontier Markets?

Morgan Stanley Capital International (MSCI) creates international indices for investors. It is generally seen as the authority on what constitutes a frontier market.

The company's MSCI Frontier Markets Index tracks the performance of about 100 constituents in 20 countries based on demographics, economic development, politics and liquidity. The countries include Croatia, Iceland, Romania, Serbia, Kenya, Morocco, Nigeria, Tunisia, Bahrain, Jordan, Oman, Bangladesh and Vietnam.

In addition, to be in the frontier markets 'club', a nation must have (at minimum) a stock-market regulator and no restrictions of withdrawing investments (when events turn bad).

However, Many Frontier Markets Have One-Dimensional Economies

Not only do these nations suffer from immature economies and stock markets, low levels of income per capita and limited investment opportunities, but many are also one-trick ponies.

For example, many frontier markets in the Middle East have economies that are heavily reliant on oil.

Others used to be part of the old Soviet Union and continue to struggle in rebuilding their economies, while many frontier market countries are limited to just agriculture and mining.

Frontier vs. Emerging Markets: Is There a Difference?

Well, yes there is.

Brazil, Russia, India and China are considered emerging markets. Investors dubbed them the BRIC nations, as they sit heavily at the top of the emerging market food chain.

BRIC gets the whole idea behind free markets and free trade. But for years they have been hobbled by excessive government control of their economies.

However, they are now far more industrialised, also investing more in their production capacity and expanding their economies beyond primitive, singular industries like agriculture, energy, and mining. In addition, they have thriving stock markets and rising incomes, while spreading the wealth to their citizens more than in the past.

But despite spreading the wealth, BRIC and other emerging markets remain unable to join the world of developed markets because most of their citizens have lower-than-average per capita income compared with those in developed markets.

The World Bank, for example, defines developed countries like the UK, USA, Australia, Singapore etc., as those whose citizens have a per capita income of more than $3,895.

Why Invest in Frontier Markets?

It's all about the risk-reward trade off.

Frontier markets are clearly risky bets, but some member nations, when they get their acts together or experience a string of good luck, can be an investor's best friend.

We're talking about poor countries that are scraping the bottom, which means they have great potential for growth.

After all - What else do they have to lose?

Historically, frontier markets tend to produce higher economic growth rates on average than developed or emerging markets. They also typically exhibit a low correlation (they zig when others zag) to other asset classes like the stocks of developed nations, or even emerging markets.

Also, many are not hopeless cases.

In fact, most have hard-working and resourceful citizens whose pent-up energy and desire to live a better life is typically held back only by government corruption, graft, and ineptitude. Once those obstacles are dismissed or neutralised, their economies can begin to grow organically.

Good Morning Vietnam

Take Vietnam, for example.

The Southeast Asian country is one of the fastest growing economies.

Investors who know Asia see similarities between Vietnam and the China of two decades ago when its masses of poor workers started to become less poor and started upping their consumption of goods and services.

But investors also see opportunities beyond Vietnam. Some African countries are getting a close look as they improve their public finances and win international financing.

The Drawbacks

Risk, illiquidity, and volatility are the biggest concerns. In places like Europe and the USA, there are layers of rules and regulations governing commerce, corporations, and stock markets. Many frontier markets do not have these, and if they do, oversight is often weak and ineffective.

Many frontier market companies also have poor corporate governance. They're not transparent about their operations, financing, and management structure.

Those are risky investments, and it can be like flying blind.

Additionally, these companies are in a weakened position should misfortune strike, such as an earthquake that destroys a factory, or terrorists who blow up a shopping center. Many are unable to recover because they do not have either spare money or access to loans;- the core liquidity they need to withstand losses and make a comeback.

The final concern is volatility.

Most investors are looking for something reliable and with consistent returns, with predictable ups and downs, not extreme rollercoaster-like returns.

However, a look at the MSCI Frontier Markets Index shows that in 2017 it increased 35.31%, in 2018 it decreased 16.78% and in 2019 it increased again, this time by 19.16%.

That's volatility on steroids!

How to Invest in Frontier Markets

Should you fancy putting a (hopefully small) proportion of your portfolio into frontier markets, the best way to invest is probably exchange-traded funds (ETFs). (Can link to the ETF article here)

There are a number of dedicated frontier markets ETFs available, including; Guggenheim Frontier Markets, Global X Next Emerging and Frontier, and the iShares MSCI Frontier 100. Typically, they do give investors broad exposure across the frontier market landscape, which should reduce volatility concerns somewhat.

That said, investing in frontier markets is not for the inexperienced. But adding a small portion of these struggling yet hopeful countries to an investment portfolio might make a lot of sense.

It's all about diversity (with a bit of risk), isn't it?