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OPINION - EMERGING MARKETS

A step beyond into Frontier markets

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At this stage, nearly everyone has accepted emerging markets are the next big thing.

Fundflows into markets like China, Brazil and India soared last year as investors everywhere grasped the implications of changing geopolitical power patterns, demographic trends and economic growth projections.

The practices and limitations that previously kept some economies in the "emerging" category – runaway debt, high inflation, weak currencies, market volatility, outbreaks of crushing illiquidity, as well as poor corporate governance and corrupt administrations – well, that sounds like somewhere rather closer to home.

But not content with the respectable returns from emerging markets now richly deserving investor support, some managers are venturing a step beyond. There is a flush of excitement about so-called "Frontier" markets – a handful of locations that make for superb photo opportunities on fund brochures and hyperbole from the marketing teams.

A good old Greater China Opportunities fund? A boring Asia Pac ex Japan? No thanks. Bring me your Vietnam Infrastructure, your Sudan Special Projects or your Gabon Natural Resources.

Already we are getting the long/short versions, as well as the ETF, just so there is a counterparty for the professionals to play with. The money is pouring in, making for some quite fancy valuations in these little outposts.

Merrill Lynch, which has a Frontier markets index, defines them as 'countries with a developing economy and an undeveloped equity market', where market risk is balanced by growth potential. What they actually are is undercapitalised, weakly regulated fiefdoms offering Emerging Extreme for fund managers swaddled in key-man insurance.

It is safe to call this outbreak of Frontier-itus insane, for 90% of retail investors. There is a gulf between a strategic quest for higher returns, and a one-colour bet with loaded dice. Frontier investing is supposedly a spin-off from the greater emerging-market proposition, which is a very good one. But like the local infrastructure, it breaks down as you cross the slightly unstable border.

If the client, adviser and manager are all hardened market pros ready and able to tangle with the locals in their own back yard, frontier markets do offer a thrill, especially in the telling. The returns, like the ride, are volatile, and if you believe such markets are not correlated with emerging or developed markets, you were not around in Asia in 1998.

Frontier managers based in London or New York say distance lends judgement to their view: they have locals, who key them in. Nice theory, which would probably hold for a more established target. But local information no longer automatically goes from the spoke to the hub. The manager may not even know what opportunities have been missed.

Secondhand information is notoriously unreliable and the odd visit does not yield the same understanding or contacts. Insider trading? In frontier markets, there is another word for that: Business. The old saying 'If you don't get the joke, the joke is on you' springs to mind.

However, there are regional managers who truly understand their patch and have also built credibility in global financial centres. Take East Capital, where CEO Karin Hirn speaks seven or eight languages, or SilkInvest, where multiple Arabic dialects embed the manager in Mena markets. Among the global players: Barings, Templeton and HSBC.

But if the client has grown a risk appetite with the Spring, there are plenty of cheaper options closer to home. With sterling sagging, we will not be able to afford anything else.



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