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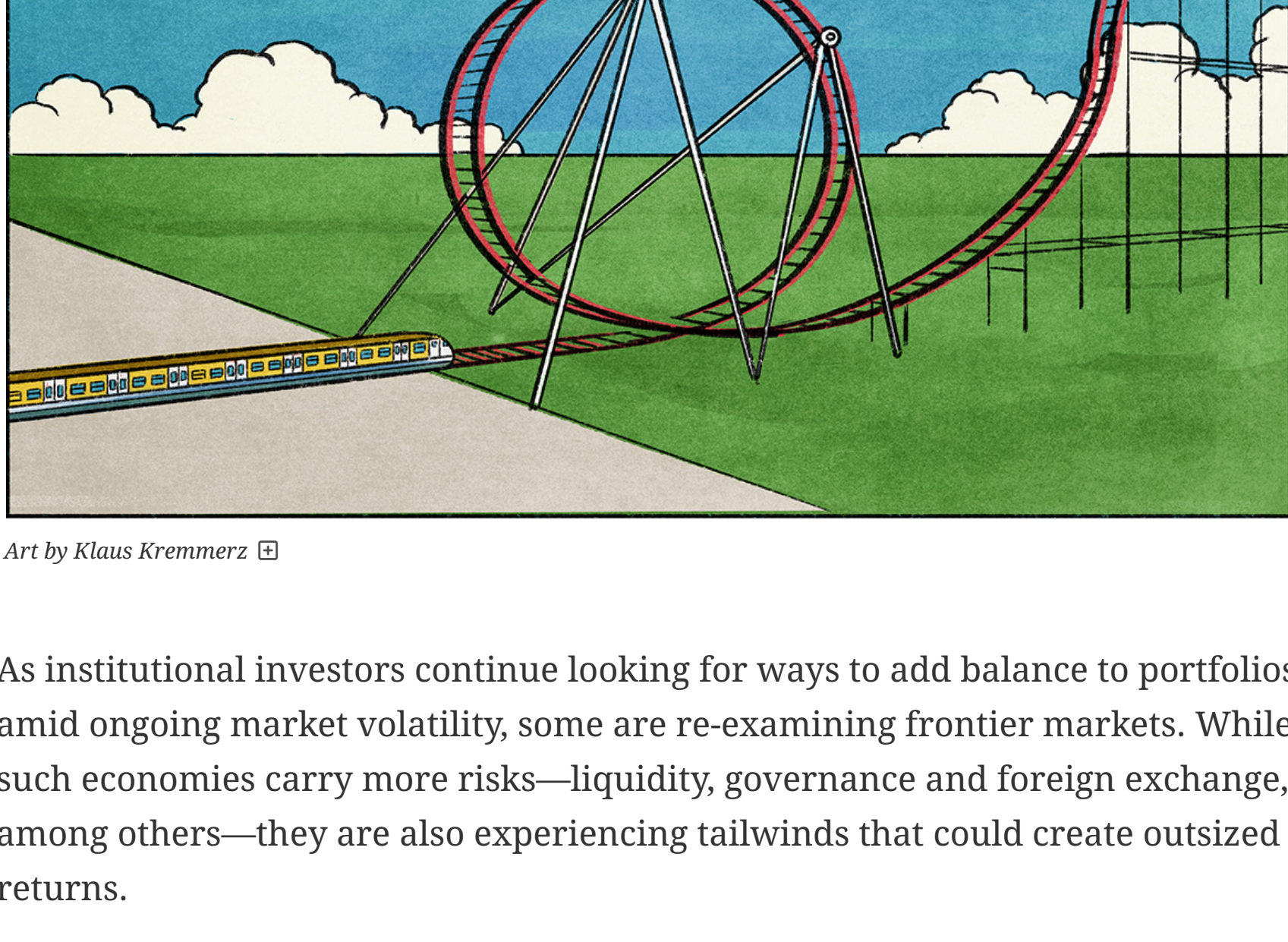
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Asset Allocation August 1, 2023

# Investors See Opportunity (and Risk) in Frontier Markets

Digital transformation and urbanization are driving growth, as well as supply chain reshuffling.

By Beth Braverman



Art by Klaus Krennmerz

As institutional investors continue looking for ways to add balance to portfolios amid ongoing market volatility, some are re-examining frontier markets. While such economies carry more risks—liquidity, governance and foreign exchange, among others—they are also experiencing tailwinds that could create outsized returns.

“One of the most interesting trends is the growth of consumption in these markets,” says Sergey Dubin, portfolio manager for frontier markets equity at Harding Loevner LP. “You have young populations that are moving from villages, where they earned a subsistence living, to cities, where they get higher-paid jobs in manufacturing. As their income goes up, their demand for all kinds of discretionary products also accelerates.” That consumption trend is also supporting a shift in the retail landscape, from mom-and-pop stores to organized chains. At the same time, these new consumers are looking for banking solutions and turning to smartphones and fintech apps to manage their money and complete transactions, Dubin says.

Such trends create opportunity for investment. Dubin says he is following Kaspi.KZ, a fintech company in Kazakhstan that began as a digital lender but has evolved into a “super app” that allows users to manage money, pay bills and purchase goods.

While most developed counties have experienced little to no gross domestic product growth in the past year, countries like Indonesia and Kenya are growing at 5% or more, says Yalin Karadogan, partner and head of investor solutions at LeapFrog Investments.

“We’re not feeling that recessionary feeling in most of our countries that we invest in,” he says. “If anything, we are seeing buzzing, happening economies with companies getting access to financing and delivering really high company growth rates.”

Karadogan says that within emerging economies, LeapFrog is looking specifically at companies in health care, financial services and climate solutions, with an eye toward impact. That strategy is drawing increased interest from institutional investors, he adds.

“Our investments really touch the emerging consumers, and they not only generate positive impact in their lives, but they’re also able to get fantastic growth rates,” he says. “These sectors also tend to be driven by technology to a certain extent.”

## Supply Chain Reshuffling

Another trend benefiting some frontier markets is a continued shift in global supply chains as international companies look to expand beyond total reliance on China or any single market.

“In addition to the economics, U.S.-China trade and policy tensions are causing big question marks for U.S. business, and one aspect of this is the uncertainty of a China-Taiwan war,” says Ashish Chugh, the global emerging market portfolio manager at Loomis, Sayles & Co. “That was brought home when Russia invaded Ukraine. Something that seemed distant and unlikely became top of mind. If Russia can do it, why can’t China?”

Such sentiment has benefited places like Vietnam, Dubin says, which has a young, literate population and benefits from lower manufacturing costs. In recent years, Vietnam has been moving from manufacturing apparel and furniture into higher-value products, including electronics such as smartphones and computers.

Some Eastern European countries are also benefiting from growing manufacturing sectors, as well as an increase in tech outsourcing. Romania, for example, has done a good job managing inflation and growth in recent years.

“Romania recently had a very big IPO of one of its utilities [Hidroelectrica] that brought in billions of capital from foreign investors,” Chugh says. “That was a big success. There are some bright spots in frontier markets, but you can’t paint everyone with the same brush.”

Chugh says that when looking at frontier market investments, it is important to consider not only the business itself, but also the country’s political stability, trade deficit and the resilience of its economies.

“If the country doesn’t have a diversified economic base, it’s vulnerable,” he says.

Karadogan says his firm considers foreign exchange risk when making investments, looking for returns that can offset even large currency swings. If a company grows revenue at 30%, for example, but the currency moves down 10%, that’s still a 20% gain.

Still, many institutional investors remain wary of the risks involved in frontier markets, which have delivered inconsistent returns for much of the past decade due to multiple exogenous events that have stymied growth.

“Sentiment around emerging markets has been pretty poor, and frontier markets are the redheaded stepchild of EM,” says Scott Thomas, lead portfolio manager for frontier emerging small companies at Wasatch Global Investors.

“If people aren’t interested in EM, they’re even less interested in frontier markets.”

However, some institutional investors are turning back to frontier markets now, drawn by the belief that some may be less correlated with the trends that drive emerging and developed markets, making them a useful tool for portfolio diversification.

“The correlations are also low across these countries, which could be a positive from a portfolio diversification standpoint,” Thomas says. “Economically, what’s happening in Bangladesh is different from what’s happening in Argentina or Vietnam or Colombia. So when you put that into a portfolio, you can lower the risk and lower the beta of the portfolio overall.”

Thomas says the growth of smartphones in such countries is a major driver of significant opportunity.

“Six or eight years ago, you didn’t have the level and data and mobile phone usage to create a digital consumption platform,” he adds. “That’s creating a lot of possibility for growth in these new markets that’s attractive and exciting.”

Tags: [Ashish Chugh](#), [Harding Loevner LP](#), [Indonesia](#), [Kazakhstan](#), [Kenya](#), [LeapFrog Investments](#), [Loomis Sayles & Company](#), [Sergey Dubin](#), [Special Coverage: Emerging Markets](#), [Wasatch Global Investors](#), [Yalin Karadogan](#)



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# Emerging Markets Remain Under Pressure

Investors looking for global diversification have had a tough time in recent years, but there are pockets of opportunity.

By Bailey McCann



Art by Klaus Krennmerz

The past few years have been rough for emerging markets investors and downright bad for frontier market investors. Geopolitical concerns, tight liquidity and changes in the benchmark indexes have made it difficult for investors to find places that feel solid enough to invest. Money managers investing in these markets have pointed to a few pockets of opportunity, but investors will have to be wary, as it may be difficult to exit quickly if conditions change.

According to a recent analysis from emerging markets investor Gramercy, global economic activity held up relatively well in the second quarter of the year. Purchasing Managers Index strength in emerging markets and developed markets is pointing to a global growth rate of 2.8% for the first half of 2023. GDP growth in emerging markets is also starting to catch up, and Gramercy predicted this trend will continue into the third quarter. Inflation, too, has remained lower than analyst estimates. These positive trend lines could help markets that rely on emerging and developed markets to purchase their goods and services.

## The China Effect

A big piece of the puzzle, however, will be China. Gramercy noted that the economic data out of China in the first half of the year remain soft, and fiscal stimulus is likely forthcoming in the back half of the year.

If that happens, it could be a positive for key markets like Vietnam, says Luke Barrs, head of fundamental equity client portfolio management at Goldman Sachs Asset Management.

“China is trying to domesticate its growth so that more of it comes from consumers and less of it comes from government spending,” he explains. “As that happens, it could be a positive for [Association of Southeast Nations] countries that ship into China, because it is their closest large consumer market, or [that] are part of a China-plus-one supply chain strategy, but that’s going to take some time, and much of it depends on a rebound within the Chinese economy.”

ASEAN countries, including the Philippines, Indonesia, Malaysia, Thailand and Vietnam, have been playing a bigger role in the global supply chain, which has boosted their economic prospects, but Barrs points out that there are still numerous hurdles for investors in these countries: They have small economies, with few listed companies, and liquidity is lower, which can make it challenging to exit positions quickly.

These countries can also be prone to big price swings as investor interest ebbs and flows. Barrs says Vietnam is one key example. Vietnam has a large handful of high-quality, listed companies, which makes it attractive to investors. Yet it is still a relatively small market, so the opportunity can be limited. “We are positive on a few consumer companies in Vietnam, for example, but they are getting expensive now, in part because of growing investor interest,” he says.

## Index Changes Come With Trade-Offs

China is not just playing a big role in the economic prospects of ASEAN countries; it also has a big influence on emerging and frontier market indices that investors track for their global allocations. China accounts for 30% of the MSCI Emerging Markets Index, and when its companies drag, they take the entire index with it. For comparison, the MSCI Emerging Markets ex-China Index was [up 12% for the year through June 30](#), compared to the MSCI Emerging Markets Index, up just 1.75% over the same period.

Trends like that can be problematic for countries like Vietnam, which currently makes up 30% of the frontier markets index. If the country eventually moves into the emerging markets index, it goes from being a big, investible fish in a small pond to a medium-sized fish trying to compete in a much larger body of water. If countries like Vietnam left the frontier markets index, it might also make it more difficult for investors to use that index reliably, because it would have fewer anchor constituents that have multiple listed companies.

Some money managers appear to already be doing that math. As of June 1, iShares [converted](#) its \$707 million MSCI Frontier and Select EM ETF to active management, dropping the peg to the MSCI indices and dropping the MSCI name from the title. According to BlackRock, the shift to active management should give the fund greater flexibility to respond to shifting market conditions.

“We think the jury is still out on whether the frontier market index is a viable index,” says James Donald, managing director and head of emerging markets at Lazard Asset Management, which invests in frontier markets through select actively managed strategies. “It’s challenging to take a broad brush to frontier markets—these countries have a lot of limitations, which is evident in how frequently index constituents come under review.”

Donald notes that Nigeria, another frontier market, has several interesting investment themes but is under review because of geopolitical shifts in the country that make it a difficult place to invest. There is a possibility of Nigeria moving to its own index, which could make it more challenging for investors to track. “Nigeria reminds me a lot of Brazil 25 years ago,” says Donald. “There are a lot of interesting trends there from an investment perspective, but there are a lot of limits.”

## Diligence Still Required

Both Barrs and Donald are broadly constructive on emerging markets and some pockets of frontier markets. But both are quick to point out that the indexes often do not tell the whole story.

Barrs is positive on parts of Eastern Europe, given recent efforts by countries like Slovenia and Romania to move toward sustainable energy sources. Persian Gulf countries, too, he says, have relatively broad consumer markets and are working on removing some investor limitations, which is a positive trend over the long term.

“Current valuations in emerging markets and some frontier markets are very attractive,” Barrs says. “That’s driving some investor interest, but in market conditions like these, investors have to be diligent. Many of the core challenges, like low liquidity, still remain. You have to be willing to look company by company.”

Tags: [ASEAN countries](#), [China](#), [Goldman Sachs Asset Management](#), [Indonesia](#), [Malaysia](#), [Persian Gulf](#), [Philippines](#), [Romania](#), [Slovenia](#), [Special Coverage: Emerging Markets](#), [Thailand](#), [Vietnam](#)

