Emerging market investing

Investors hunt for hidden frontier market gems

Risk improves as financial infrastructure matures and a middle class emerges

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For investors with an appetite for risk, countries such as Kenya offer the potential for high returns © Aleksandar Todorovic/Dreamstime

YESTERDAY by: **Jennifer Thompson**

As the world's biggest asset manager, BlackRock has the resources to send its employees to all corners of the globe.

But while the majority of that business travel involves unremarkable visits to the world's financial capitals, a small band of fund managers regularly journey to more intrepid destinations.

Since the beginning of the year, six members of its frontier markets team have visited 14 countries, including Colombia, Pakistan and Kenya, in a quest for the holy grail: fast-growing listed companies that remain almost completely unknown to investors.

"There is always something you learn on the ground," says Emily Fletcher, co-manager of the BlackRock Frontiers Investment Trust, who singles out a biscuit maker in Bangladesh as one of the team's star finds. "The availability of research is lower but that puts us at an advantage in our ability to add alpha."

Frontier market does not mean basket case, but putting money into economies such as Nigeria, Vietnam and Argentina — characterised by low liquidity and a high degree of political risk — does require nerves of steel.

The MSCI frontier markets index lost 30 per cent of its value between its August 2014 peak and the end of 2016, amid sluggish global growth and the end of the commodities boom.

There are signs that the situation is changing. Since the beginning of 2017, the index has gained around 13 per cent and fund managers attest to an uptick in interest after two torrid years.

"Obviously they are still very immature and not as liquid as the big markets," says Carlos Hardenberg, director of frontier market strategies at Templeton Emerging Markets, part of the Franklin Templeton group. "But the risk environment is improving in general, gross domestic product growth is growing [and] liquidity is growing."

Last month Franklin Templeton reopened its Templeton Frontier Markets fund to new investors having closed it to them in 2013. That decision was prompted by concerns that having $3.6bn of assets under management, at its peak, was too much in the context of the potential volatility and fragility of commodity markets.

Also rejoining the quest is Seven Investment Management. The London-based investment manager recently re-established frontier market positions in their "adventurous" funds, with a 2.5 per cent exposure to Charlemagne Magna's new frontiers fund and another 2.5 per cent in a frontier markets fund managed by T Rowe Price.

Tony Lawrence, a 7IM investment manager, says he would like to see this exposure increase.

The pay-off for their buccaneering spirit could be high returns: the share price of BlackRock's Frontiers Investment Trust has risen 39.1 per cent over the past three years.

The amounts involved are small. Franklin Templeton's fund now has assets under management of $1.2bn; the sharp drop a reflection of the high level of redemptions as well as share price falls. At 7IM they are tiny, with £10m spread across Charlemagne and T Rowe Price.

But they attest to fresh confidence that frontier economies will notch up strong growth as their financial infrastructure matures and a consumer-driven middle class emerges from their sizeable populations.

Frontier funds recorded two consecutive months of net inflows in January and February, the first time this had happened in almost two and a half years, according to EPFR, the data provider. Net outflows were close to $1.65bn last year, but so far in 2017 they are on track to be less than half that.

The recent departure of Pakistan from the 29-member strong MSCI index, after it was reclassified as an emerging market, has not troubled managers, as the grouping is not regarded as prescriptive. Most frontier investment vehicles are actively managed and stock pickers relish the chance to make bold choices.

> The turning point was a combination of locals and foreigners seeing the end of Isis in Iraq
> **Henrik Kahm, FMG Funds**

Henrik Kahm, an investment analyst at FMG Funds, which specialises in emerging and frontier market investments, continues to have faith in Iraq despite witnessing heavy outflows in FMG's Iraq fund over the past two years as crude slumped and Isis, the Islamist group, took control of swaths of the country.

"It was a massacre on the stock market," he recalls. "There was no place to hide — all sectors were hurt." The fund had $20m in assets in 2010, which had halved by last year. But now things are looking up, with the fund receiving more inquiries from investors in the past two quarters.

Though it has been little more than two weeks since Franklin reopened its fund, Mr Hardenberg also says investors are keen to find out more. On top of the potential returns, he argues that prospective stock market listings, such as that of VietJet, the low-cost Vietnamese airline, have inspired confidence.

Mr Kahm regards the offensive in recent months by Iraqi forces to regain the Isis-held city of Mosul as the turning point for investors. "It was a combination of locals and foreigners seeing the end of Isis in Iraq," he says, adding that the election of Haider al-Abadi as prime minister in 2014 was also positive.

The prospects of other leading, but crisis-hit, frontier economies also appear to be improving. Nigeria, whose dependence on oil exports pushed it into recession last year, launched an ambitious $6.9bn infrastructure spending plan last month.

Egypt, while still plagued by political instability, has been lauded by investors for allowing the currency to float last November as part of a package of reforms necessary for securing a $12bn loan from the International Monetary Fund.

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Nevertheless frontier markets still have a long way to go before they return to their pre-2015 level. "Risk appetites are still not where they used to be," says Mr Hardenberg, an attitude the manager shares with his clients. Franklin has set targets for how big they would like the fund to grow but not even the uppermost figure

surpasses $3.6bn. “We are really trying to be conservative here,” he adds.

But the risk is still worth it, argues Mr Lawrence, “if you’ve got a truly global manager who can travel and unearth well-hidden gems”.

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