Q&A

New Frontiers: A View of Opportunity, Risk and the Unique Dynamics in Frontier Markets Debt

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Frontier markets are the smaller, less economically developed nations of the emerging market (EM) sphere and may offer opportunities for significant growth. David Motill, Conning's Head of Consultant Relations, speaks with Christian Mejrup, Deputy CIO of EM Sovereign Debt for Global Evolution (a Conning subsidiary) about the unique economic and political dynamics within frontier markets debt and why the asset class may be a good diversifier in a fixed-income portfolio.

A Definition of Frontier Markets

1. **David: *What is Global Evolution's definition of a frontier market?***

   Christian: In our analysis of the investment universe we use the following three characteristics in classifying frontier markets countries. First and foremost, frontier markets are typically subject to greater political risk due to the lower levels of regulation and weaker institutions. Second, from a macroeconomic perspective, frontier economies are typically smaller and less established, but exhibit higher economic growth rates. Third, the investor base in frontier markets is more concentrated and reflects a higher level of domestic ownership of their sovereign debt.

2. ***Can countries move from emerging back to frontier? What factors can influence the re-classification?***

   Countries rarely move from emerging back to frontier as their evolution is based on economic maturation that often takes decades to unfold, in either direction. In fact more often we see frontier markets mature and move toward an emerging markets classification.

   For example, in 2010, Serbia had characteristics of a frontier country, which included a weak political framework, volatile economy, and sovereign bond yields trading in the double-digits. Over the last decade, we've seen tremendous positive developments in Serbia, kick-started by an IMF program. The nation has become a poster child in meeting all the structural reforms mandated by the IMF while its economy has begun to converge with neighboring countries such as Poland and Hungary. Consequently, yield on five-year debt is now at 2.5% and the investment case is no longer suitable for a frontier strategy.[1]

3. ***How has investing in emerging market debt evolved since the 2008 financial crisis? How large and liquid is the frontier debt marketplace? What is an appropriate benchmark for frontier debt?***

   Frontier countries today have a $550 billion market capitalization across 85 investible countries, up from $250 billion in 2010.[2] This increased level is largely a result of sensible investments in human capital, health care and infrastructure, but also a reflection of high economic growth rates. This added debt burden is not a concern for us, as long as it is achieved in a sustainable way.

   Liquidity in frontier markets has improved significantly over the years and is much better than commonly believed. Analyzing the hard currency and local currency sub-asset classes of frontier markets reveals two very distinct liquidity sources. It is therefore highly beneficial to break down the frontier debt universe into local currency and hard currency and examine their respective features.

Hard currency debt issued by frontier markets tends to be more volatile given its greater ownership by international investors from advanced economies. As a result, hard currency debt is more sensitive to changes in global risk sentiment both from a performance and liquidity standpoint.

Local currency debt, on the other hand, often has much lower levels of foreign participation (often less than 10% on average) with the majority of investors being domestic banks, pension funds and insurance companies. Consequently, local currency debt exhibits lower and more idiosyncratic volatility and is more likely to be impacted by domestic risk events such as inflation, monetary policy, fiscal performance and the balance of payments.

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- Christian Mejrup

In sum, using a combination of both hard currency and local currency instruments greatly improves the liquidity and risk profile.

There is no ideal benchmark for a blended frontier fixed-income approach and generally we believe investors should look at the asset class as an alternative to traditional emerging markets debt. JPMorgan has launched a NEXTGEN Index which represents the hard currency debt of just 35 countries and thereby leaves out a big part of the total opportunity set of countries. In addition, the index leaves out the local currency sub-asset class completely, which represents two-thirds of the market capitalization. Therefore, we adopt a benchmark-agnostic approach and use a more absolute strategy in our portfolio construction.

4. *Are risks significantly different between frontier versus emerging market investments? Is there a misconception of risks in these markets?*

In theory, the risks are not significantly different as investments are based on both fundamental economic and political analysis. However, risks are generally more pronounced in frontier countries as elections carry higher political risks: for instance, there is the likelihood that not only the finance minister might be removed from power but the entire administration as well. This stands in contrast to an emerging market where the minister alone would be voted out of office. In addition, risks are higher in each individual frontier country compared to emerging countries due to the former's less developed institutions and weaker economic and political structure. Another hurdle to investing in frontier economies is investment size. Larger investors may not be able to make a sizeable investment in a frontier country. For example, it's difficult to make the case for an investment in Mongolia if 1% of your allocation is equivalent to the country's outstanding debt. The costs of analyzing Mongolia's legal framework, settlement procedures, developing contacts and setting up trading lines with local investors is high if you can only allocate 0.1% of your portfolio to the country. It therefore makes sense to invest with managers with a significant amount of expertise in frontier markets.

As we assess these various risks and challenges, it is equally important to touch upon some common misconceptions. First, there is often a misunderstanding as it pertains to correlation levels and the possibility of contagion which we can easily deconstruct: frontier economies often have very little in common with each other. In fact, they have a very different import/export mix, different trading partners, and they trade little with each other. This means inter-country correlation is low and one frontier country's economic difficulties or crisis is unlikely to have a domino effect on other countries in the portfolio. Therefore, given the low inter-country correlation, it makes sense to increase the number of countries in a portfolio in order to diversify away volatility risk.

Another misconception is the impact of global risk sentiment on these markets. Foreign investors tend to de-risk when global financial headlines turn negative regardless of an asset's fundamental value. Therefore, a higher concentration of foreign participation in a market typically leads to a higher correlation with global risk sentiment. As we indicated previously, there is generally a lower level of foreign participation in frontier economies – this means they are therefore less exposed to a global market selloff and less susceptible to capital outflows.

The Case for Investing in Frontier Market Debt

5. ***What are the benefits of adding frontier market debt to an investor's portfolio?***

Frontier markets represent an untapped opportunity set, reminiscent of the one offered by emerging markets such as Brazil and Mexico 20 years ago. Indeed, many frontier countries share similarities with the BRIC countries – the same attributes which made them so attractive to investors two decades ago. Strong performance potential stands out as a key parallel: the high projected real GDP growth of frontier markets over the next 5-10 years indicates they should deliver strong outperformance for many years to come. Performance drivers include untapped natural resources, foreign direct investments and the improving political and economic governance and development of local financial markets. Furthermore, frontier markets are a less crowded trade given the very low participation from foreign investors. These markets also present a compelling investment opportunity given the inefficient valuations stemming from the common misconceptions surrounding their political and economic risks, and from their less mature financial markets.

We believe frontier fixed income serves as a good diversifier within a fixed income portfolio while it also offers a rare high carry/yield to maturity which has notably resided in the double-digit range for most of the past decade.

6. ***How impactful is the current low price of oil on frontier markets?***

While low oil prices affect oil exporting countries, it's important to note that a large number of frontier countries are also oil importers. In fact there are about 10 frontier markets that are highly dependent on oil revenues. At Global Evolution we take a prudent approach by diversifying our exposure across importers and exporter including our diversification to other commodities such as agricultural products, iron ore, and copper.

7. ***What is your outlook for frontier debt? Where are the opportunities?***

Valuations are currently attractive for long-term investors. Historically, it's been shown that after significant drawdowns, most emerging market and frontier asset classes have exhibited strong recovery rates. At Global Evolution, we analyzed the aftermath of the 10 largest monthly drawdowns and subsequent bounce-back in returns. The average fall in prices was 3.3% during those one-month periods, but the average performance of the assets during the subsequent 12 months was a 10.75% gain.[2]

Why Global Evolution's Frontier Market Strategy?

8. ***What is the value of experience in investing in frontier debt? What differentiates Global Evolution?***

Frontier countries are smaller economies with less publicly available information. These inefficiencies mean one must invest in additional resources to gain the insights needed to invest with confidence. The mainstream EM countries typically get ample coverage from researchers, economists and analysts; the opposite holds true for frontier countries. Hence there is asymmetric information available for managers such as us who dig in deeper, analyze data and information through proprietary models and perform the ongoing due diligence trips needed in these countries.

In addition, while one must always be mindful of the data from any country – even China and the U.S. – this is even more pertinent in frontier countries. Given the large structural changes unfolding and the lag in updating GDP and inflation calculations in frontier markets, local country knowledge is imperative to interpret these numbers.

Global Evolution offers several comparative advantages. First is our deep expertise in frontier markets which allows us to actively navigate the space very skillfully, while our active country allocation allows us to avoid deteriorating countries and focus on dynamically improving countries.

Second is our high level of retention and the cohesiveness of the investment team. We also employ a team-based approach; for example, each strategy is managed by two portfolio managers, which minimizes key-man risks.

Third, we have always been and remain an EM fixed-income-dedicated boutique with no style drift into other asset classes. We are committed to sticking to our knitting.

Fourth, we also offer a significant edge in our ESG and SDG focus. Our ESG approach is in fact a rather contrarian methodology which integrates positive ESG momentum and AI sentiments into our valuation models. This informs our investment process by identifying evolving countries, early stage opportunities, relative value opportunities and country warnings.

9. ***Why should ESG factors be considered when investing in frontier markets? How important is the "S" factor?***

The ESG dividend that an investor can gain from investing in frontier countries is much higher than that from emerging and developed countries.

The "S" and "G" factors are the most important when investing in frontier markets and we always analyze education, healthcare, rule of law, and business climate in detail. These factors are also very intuitive in that, if a country increases its investments in human capital or health care, it often leads to a rise in productivity and economic performance. Additionally, if a country improves the rule of law and conducts free and fair elections, it will often improve the business climate and attract more investments.

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>
> ***-Christian Mejrup***

We believe there is a clear business case for incorporating ESG into the investment process and essentially no downside as investors do not miss out on opportunities or give up performance by including ESG into their sovereign investment allocation decisions.

Christian Mejrup is Deputy Chief Investment Officer of EM Sovereign Debt at Global Evolution, responsible for formulating hard currency and local currency strategies with special focus on frontier countries. Prior to joining the firm at its inception in 2007, he held a position in Sydbank where he was part of the successful investment management team responsible for emerging markets fixed income and FX mutual funds. Christian holds an MSc in business & finance from University of Southern Denmark.

David D. Motill is a Managing Director and Head of Consultant Relations at Conning. Prior to joining the firm in 2010, Mr. Motill was a partner and chief marketing officer at Alpha Equity Management. He previously headed consultant relations groups with Fischer Francis Trees & Watts, Citigroup Asset Management and GE Asset Management. Mr. Motill earned a degree from Temple University and an MBA from the University of Notre Dame and holds Series 7 and 63 licenses.

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FOOTNOTES

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[2] Global Evolution data

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