

## FACING NEW FRONTIERS

These markets have been providing brave investors with impressive returns, but don't forget about the risks

**T**he myth of the frontier exercises a powerful pull on the American imagination. When things get too settled and predictable, so the thinking goes, hardier souls can strike out for new territory to seek sterner tests and potentially greater rewards. The problem with the frontier, of course, is that it keeps moving. Yesterday's frontier is today's bedroom community.

In the financial world, emerging markets mature and become increasingly correlated with the developed world. Restless investors are seeking increased diversification via markets that aren't interconnected with the United States. But while frontier markets have produced impressive results lately, they have unique drivers and risks that must be understood before lighting out.

Frontier markets, sometimes referred to as "emerging emerging," are principally in Asia, the Middle East and Africa. The number of frontier markets depends on who's doing the counting and what the criteria are. The S&P/IFCF Index comprises 24 countries, while the MSCI Frontier Markets Index lists 19. The lure is clear: potential profits. The S&P/IFCF Index returned nearly 46% in 2007. Bangladesh and the Ivory Coast each returned over 120% while the Ukraine clocked in at over 110%.

Some of the returns may be driven by cash flows into the regions, particularly from funds attracted by the frontier markets' lack of correlation with the developed (and even emerging) markets, as well as recent lack of volatility in the asset class. But for the most part, fundamentals within the regions are driving the growth. Here are some factors to keep in mind about this asset class:

**Fundamental drivers:** Natural resources are a significant economic driver in frontier markets, but some analysts believe that we're beginning

to see broader-based, more sustainable growth. An increased appetite for consumer goods is one driver, but perhaps of equal importance is the money being spent for infrastructure improvements (e.g., Africa's massive projects for roads, bridges, telecommunication, housing and power supply). These expenditures may offer extremely attractive opportunities for investors and dealmakers.

**Small and illiquid:** Despite the rush of investment into frontier economies, the capital markets are still very immature. Even by emerging-market standards, they are small and illiquid. Direct investment in most of these countries is well beyond the reach of most retail investors. That illiquidity has other inherent risks. Simply put: One major player or business failure can have an enormous impact on stock prices, both positive and negative.

**Local knowledge a must:** Capital markets are increasingly global, but frontier markets still require a local touch. Understanding the players involved and the unique methods of doing business are a necessity.

**Stability can be short-lived:** During the 1970s, Africa enjoyed a commodities boom—and a decade of unprecedented unrest. By comparison, many African countries today are stable or stabilizing. Still, the potential for political and social unrest (as well as fallout from Africa's health crisis) is ever-present.

Over the next few years, you can expect to see an increasing number of vehicles providing investors exposure to frontier markets. The returns have been attractive and the drivers appear to be long-term and mostly positive.

But do not ignore the risks. After all, some pioneers along the frontier found the fortune they craved, and some found themselves longing for the civilization they'd left behind. ■



\* *Investors are seeking markets displaying economic drivers not correlated with U.S. markets.*

\* *The potential for political and social unrest in these markets is ever-present.*

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