Verging on Emerging
The 7Cs responsible for surging interest in global frontier markets

By David Wickham

August 2013
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Verging on Emerging:
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1. Commencement

In medieval times, traders travelled the “Seven Seas” in their voyages to the East in search of silks, spices, and other supplies. In the ninth century AD, Ahmad al-Ya’qubi, perhaps the first historian of world culture in medieval times, wrote: “Whoever wants to go to China must cross seven seas¹, each one with its own color and wind and fish and breeze, completely unlike the sea that lies beside it”. These trade routes to the East served primarily to transfer raw materials, food products, and luxury goods; for instance, China supplied West Asia and the Mediterranean world with silk while spices were mainly obtained from South Asia. These goods were transported overland or by sea along the Silk and Spice Routes, and were the main arteries of contact (and conduits for the spread of Islam) between the various ancient empires of the Old World.

In the same way as the demand for silk and other luxury goods facilitated the Silk and Spice Routes, (stock) traders these days are navigating a different route in search of ‘alpha’ opportunities across the frontier world. Investor interest in global frontier markets – those 60+ countries with a domestic stock exchange that are pre-emerging or ‘verging on emerging’ – has been surging due to the “7Cs” that characterize the asset class, namely:

1. Comprehensive universe
2. Change
3. Consumers
4. Commodity wealth
5. Correlations
6. Cash returns
7. Cheap valuations

Collectively, we believe that these “7Cs” characterizing global frontier markets have the potential to generate superior investment returns through high dividends, capital gains, and currency appreciation for those early adopters of the global frontier markets asset class.

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¹ The Seven Seas referenced in Medieval Arabian literature include: (1) the Persian Gulf or “Sea of Fars”; (2) the Gulf of Khambhat or “Sea of Larwi”; (3) the Bay of Bengal or “Sea of Harkand”; (4) the Strait of Malacca or “Sea of Kalah”; (5) the Singapore Strait or “Sea of Salahit”; (6) the Gulf of Thailand or “Sea of Kardanj”; and (7) the South China Sea or “Sea of Sanji”. See Lunde, 2005.
2. Classifications: what are frontier markets?

There is no strict definition of what constitutes a ‘frontier market’. They are commonly seen, however, as countries capable of becoming the next generation of emerging markets. In other words, those countries with stock markets that are ‘verging on emerging’ status, either now or at some point in the future. These markets tend to be less researched and less liquid than emerging and developed equity markets, and are largely dominated by local retail investors who are typically less affected by global sentiment. We believe that the consequent pricing anomalies can create potential ‘alpha’ opportunities for active investment managers with dedicated expertise, demonstrable investment skills, and access to on-the-ground resources across disparate countries.

Frontier markets are often classified as low-income, high-risk countries that typically enjoy high economic growth rates but have made limited progress towards either political or economic stability or in developing liquid and efficient capital markets. In addition, they are generally not represented in mainstream emerging market indices.

Based on the MSCI Frontier Markets index, frontier market countries include the following 25 countries (as of April 30, 2013):
- in the Middle East and North Africa: Bahrain, Jordan, Kuwait, Lebanon, Oman, Qatar, Tunisia, and the United Arab Emirates
- in Latin America: Argentina
- in Asia: Bangladesh, Pakistan, Sri Lanka, and Vietnam
- in Sub-Saharan Africa: Kenya, Mauritius, and Nigeria; and in Eastern Europe: Bulgaria, Croatia, Estonia, Lithuania, Kazakhstan, Romania, Serbia, Slovenia, and the Ukraine

Based on this list, it is apparent that frontier markets are a heterogeneous grouping of countries – ranging from relatively low-income countries like communist Vietnam through to high-income commodity endowed countries such as Qatar – so an all-encompassing classification is challenging. Defining frontier markets in terms of high economic growth rates is also problematic for equity investors given the tenuous relationship between economic growth and stock market returns in both developed markets (as explored by Dimson, Marsh & Staunton, 2002 and Ritter, 2005) and emerging markets (as explored by Henry & Kannan, 2006). A more useful framework, in our view, is to classify frontier markets according to institutional voids and productivity within the equity market ecosystem, as illustrated in Exhibit 1.
Exhibit 1: The equity market ecosystem

<table>
<thead>
<tr>
<th>Industry Standard MSCI Index</th>
<th>Top 10 countries</th>
<th>Institutional voids</th>
<th>Productivity</th>
<th>Type of market</th>
</tr>
</thead>
<tbody>
<tr>
<td>MSCI World</td>
<td>USA, Japan, UK</td>
<td>Low</td>
<td>High</td>
<td>Developed Markets</td>
</tr>
<tr>
<td>No of countries:</td>
<td>24</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Free float market cap (USDm):</td>
<td>27,522,008</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>No of stocks:</td>
<td>1,604</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>MSCI Emerging Markets</td>
<td>China, Korea, Taiwan, Brazil, South Africa, India, Russia, Mexico, Malaysia, Indonesia</td>
<td>Medium</td>
<td>Medium</td>
<td>Emerging Markets</td>
</tr>
<tr>
<td>No of countries:</td>
<td>21</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Free float market cap (USDm):</td>
<td>3,511,051</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>No of stocks:</td>
<td>820</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>MSCI Frontier Markets</td>
<td>Kuwait, Qatar, Nigeria, UAE, Pakistan, Kenya, Oman, Kazakhstan, Argentina, Lebanon</td>
<td>High</td>
<td>Low</td>
<td>Frontier Markets</td>
</tr>
<tr>
<td>No of countries:</td>
<td>25</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Free float market cap (USDm):</td>
<td>120,027</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>No of stocks:</td>
<td>141</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: MSCI and HSBC Global Asset Management as at 30 June 2013. For illustration purposes only. Subject to change without notice.

As can be seen in the table above, frontier markets can be classified as countries with high institutional voids (hence the potential for drastically reduced voids over time) and low productivity (with the potential for significantly increased productivity over time). The notion of institutional voids is not a new concept. It was first introduced by Harvard Business School professors Tarun Khanna and Krishna Palepu in relation to emerging markets but aptly applies to frontier markets (although institutional voids in some frontier countries can be further exacerbated by the absence of hard infrastructure such as roads, airports, seaports, and reliable power generation). According to Khanna & Palepu (2005), institutional voids are transactional arenas where buyers and sellers are not easily or efficiently able to come together due to an absence of soft infrastructure such as specialized intermediaries, regulatory systems, and contract enforcing mechanisms.

According to Khanna & Palepu, these institutional voids exist:

- in product markets through underdeveloped communications infrastructure, lack of independent consumer information organizations, and a lack of redress mechanisms such as arbitration
- in capital markets through a lack of institutional mechanisms such as reliable financial reporting, a dynamic analyst community, and an independent financial press
- in labor markets through a scarcity of skilled talent and lack of certification from well-respected educational institutions
- through misguided regulation that jeopardizes managerial freedom, imposes regulatory bureaucracy, and induces bribery and corruption, and a lack of contract enforcement through inefficient judicial systems and ineffective mechanisms to enforce contracts and protect property rights
While this may not sound particularly appealing for conventional investors, it does mean that there are many obvious levers that can potentially generate positive change and rapid productivity (and hence GDP) growth in frontier markets that could, in turn, drive some degree of convergence with emerging markets over the medium to long term. The case of China is testament to this claim; in the late 1970’s and early 1980’s, China, then a frontier market by any definition, started implementing structural reforms and rapidly grew to become the second largest economy in the world. While very few countries are capable of this remarkable growth trajectory, there are numerous examples of similar positive change underway in the frontier world, some of which are highlighted throughout this report.

3. Characteristics of Global Frontier Markets: the 7Cs

Global frontier markets can be characterized by seven traits, the so-called “7Cs”, which could potentially drive superior investment returns to emerging and developed markets for those early adopters of global frontier markets as a discrete asset class:

3.1. Comprehensive universe

Global frontier markets can provide investors with access to a comprehensive and eclectic universe of highly inefficient pre-emerging markets. At HSBC, this includes both benchmark and non-benchmark opportunities. In terms of the former, our frontier markets investment universe includes the 25 aforementioned countries that are represented in the MSCI Frontier Markets index as well as 5 small emerging market countries that are considered ‘crossover’ markets; namely, Colombia, Philippines, Peru, Egypt, and Morocco. These five countries account for just 3.0% of the total MSCI Emerging Markets index as at the end of June 2013 and are considered to be frontier in nature as they currently exhibit high institutional voids and low productivity. In aggregate, these 30 countries represent the constituents of the MSCI Frontier Emerging Markets index.

While all the mainstream index providers produce frontier market indices, there are significant differences between them with respect to country and regional representation, and we believe that none of the publically available indices provide a true representation of the global frontier markets universe. The MSCI Frontier Markets index, as introduced in November 2007, has a disproportionately large weighting to the Gulf Cooperation Council (GCC) countries and make up 57% of the index, with Kuwait alone accounting for 23% of the total as at the end of June 2013, while other regions are under-represented. In recognition of this, MSCI subsequently introduced a broader index, the MSCI Frontier Emerging Markets index, in September 2008. This new index reduced the exposure to the five GCC countries by introducing the same 5 crossover countries (Colombia, Philippines, Peru, Egypt, and Morocco). However, the unintended consequence of adding these crossover countries was a disproportionately large weighting to them; as at the end of June 2013, these 5 crossover countries accounted for nearly half of the total index (47% in fact).

As a result of this skew, we partnered with MSCI to design a bespoke capped index – the MSCI Frontier Emerging Markets Capped index – that is exclusive to HSBC Global Asset Management. We believe this index more accurately reflects the global frontier markets opportunity set and provides sensible diversification across regions and countries. This index is based on the MSCI Frontier Emerging Markets index, but caps the weight of the combined ‘crossover’ markets, as well as the individual country weights, at predefined levels. This solves the issue of having too much concentration in a particular region or country. A comparison of the

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2 For the purposes of this report, the GCC excludes the Kingdom of Saudi Arabia as the country is not in the index due to foreign ownership restrictions (although can be accessed by qualified institutional investors like HSBC Global Asset Management through participatory notes).
regional allocations of our bespoke MSCI Frontier Emerging Markets Capped index with other publically available indices is shown in Exhibit 2. Our capped index helps ensure that investors gain access to a sensibly diversified universe of frontier market countries.

**Exhibit 2: Comparison of MSCI frontier market indices**

<table>
<thead>
<tr>
<th>PUBLICLY AVAILABLE</th>
<th>EXCLUSIVE TO HSBC</th>
<th>PUBLICLY AVAILABLE/ USED IN ETFs</th>
</tr>
</thead>
<tbody>
<tr>
<td>MSCI Frontier Markets</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Introduced: 30 November 2007</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Back history: from 31 May 2002</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Number of Countries: 25</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Number of stocks: 141</td>
<td></td>
<td></td>
</tr>
<tr>
<td>GCC 57% (5 countries)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>NON-GCC 43% (20 countries)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>MSCI Frontier Emerging Markets</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Introduced: 30 September 2008</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Back history: from 29 November 2002</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Number of Countries: 30</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Number of stocks: 185</td>
<td></td>
<td></td>
</tr>
<tr>
<td>GCC 30% (5 countries)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>NON-GCC 23% (20 countries)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>CROSSOVER 47% (5 countries)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>MSCI Frontier Emerging Markets Capped</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Introduced: 31 May 2009</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Back history: from 29 November 2002</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Number of Countries: 30</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Number of stocks: 185</td>
<td></td>
<td></td>
</tr>
<tr>
<td>GCC 34% (5 countries)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>NON-GCC 44% (20 countries)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>CROSSOVER 22% (5 countries)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>MSCI Frontier Markets 100</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Introduced: 11 April 2012</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Back history: from 29 November 2002</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Number of Countries: 19</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Number of stocks: 100</td>
<td></td>
<td></td>
</tr>
<tr>
<td>GCC 63% (4 countries)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>NON-GCC 37% (15 countries)</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Index is very concentrated in the GCC (57% of the total index is represented by the Middle East, including 23% to Kuwait alone), while other regions are under-represented.

Index includes all the countries of the MSCI Frontier Markets index but is broader. However ‘crossover’ countries have a disproportionately large weight (47% of the total).

Our exclusive capped MSCI Frontier Emerging Markets index ensures a broad, well diversified universe that is predominantly exposed to pure frontier countries.

Index includes all the countries of the MSCI Frontier Markets index but is broader. However ‘crossover’ countries have a disproportionately large weight (47% of the total).

Within our investment universe, we also consider frontier market companies that are listed on their domestic stock exchange but are yet to be included in the MSCI indices, such as companies listed in Saudi Arabia (on the Tadawul or Saudi Stock Exchange) or in Ghana (on the Ghana Stock Exchange), and frontier market companies that are listed on developed market or emerging market stock exchanges, such as Cambodian- and Georgian-based companies listed outside their respective countries (for example, on the Hong Kong Stock Exchange or London Stock Exchange). In total, this investment universe amounts to over 3,000 companies across 60+ countries, representing 26.5% of the world’s population and a 13.8% share of the world’s total GDP based on purchasing power parity (PPP), as shown in Exhibit 3.
Given this comprehensive universe that includes many non-benchmark opportunities, we are, as active managers of frontier market equities, willing to materially deviate from benchmark weightings and could routinely invest a meaningful amount in non-benchmark stocks. Our dedicated investment team has actively searched for overlooked non-benchmark investment opportunities in countries as far afield as Angola, Burma, Cambodia, Ghana, Libya, Mongolia, Mozambique, Papua New Guinea, Senegal, Syria, Uganda, and Zimbabwe over the last five years for the benefit of our clients.
3.2. Change

Just like their emerging market counterparts 20-30 years ago, we expect frontier markets to benefit from positive change (or relative improvements) driven by reductions in institutional voids. In particular, any reduction in these voids would support productivity growth which, in turn, should result in a degree of convergence with emerging markets. Given the starting point of these markets—with high institutional voids and low productivity—even modest improvements could generate significant productivity gains and return-on-equity for investors. Indeed, we believe this convergence presents a compelling opportunity for forward-looking investors.

The specific change agents for reducing institutional voids include:

- Improved communications and infrastructure
- Stronger capital markets through institutional mechanisms and intermediation
- Human development and the deepening of labor markets
- Improved regulation and reduced bureaucracy and corporate interference
- The introduction of effective mechanisms to ensure contract enforcement

Reductions in institutional voids have generally improved productivity through:

- Political policies that foster stability, trust, and transparency
- More effective economic institutions that encourage regulation and enforcement
- Increased knowledge accumulation and application through R&D
- Improved economic infrastructure such as technology and communications
- Improved social infrastructure such as health, education, and the empowerment of women

In turn, this productivity growth could result in greater profits and dividend distributions to shareholders, better wages and working conditions, lower prices for consumers, and increased tax payments to governments.

A constructive example of this in action is Sri Lanka, an island nation with a population of approximately 20 million which is situated off the southern coast of the Indian subcontinent. Sri Lanka has been of strategic importance since the time of the ancient Silk Road due to its geographic location and numerous deep-sea ports. It is also the oldest democracy in South Asia, although its recent history has been marred by a 26-year civil war between the Sri Lankan military and the Tamil Tigers, a separatist military organization that fought to create an independent Tamil state in the north and northeast of the island.

Since the military defeat of the Tamil Tigers in May 2009, the country has benefited from political stability that has seen a surge in foreign inflows, rating upgrades from international rating agencies, and International Monetary Fund (IMF) approval for a standby loan agreement of USD2.5 billion. It has also led to reconstruction, rising investment, and a marked pick-up in tourism. The Sri Lankan government has sought to increase investment through private sector financing, with a focus on expanding roads and ports and enhancing tourism and alternative energy. As a result of these positive changes, the MSCI Sri Lanka index posted impressive gains from 2009 through to 2011.³

³Past performance is not indicative of future performance and may not be repeated.
Another strategically important country in Southeast Asia, albeit at the earliest stage of development but with exciting long-term potential, is Burma (or Myanmar, as the country is known to those outside of the UK, USA, and Canada) with a population of approximately 60 million people. Following a coup d’état in 1962, Burma has been ruled by a military junta known for its human-rights violations that has stunted the country’s political, economic, and social development. This has resulted in a high level of dependence on China for economic support. In return, Burma provides China with access to the Bay of Bengal and hence the ability to exert influence over the Straits of Malacca/Sunda, one of the world’s busiest oil-shipping lanes. However, after fifty years of military rule, the junta has recently relinquished some control over the government. This was most prominently highlighted to the world in 2011 with the release of human-rights activist and Nobel Laureate Aung San SuuKyi, who was subsequently elected to the lower house of the Burmese parliament in 2012.

In addition to the political changes, we have seen improving relations with the USA, Japan, and the European Union, and this has led to an easing of international sanctions. Indeed, economic liberalization could open up many opportunities for private equity investors with an interest in the country’s untapped natural resources such as oil, gas, and timber. Infrastructure opportunities and tourism could also provide support. This positive view is reinforced by a Japanese convenience store franchise and Japan’s largest airline, which have both announced plans to start operations in the country. Over time, a functioning stock exchange should provide public equity investors with an opportunity to participate in the country’s growth.

3.3. Consumers
Frontier markets are notable for their large, young, fast-growing, and rapidly urbanizing base of consumers. With positive change driving productivity growth (through better technology and improved skills) and growing GDP per capita, as shown in Exhibit 4, this could enable a populous middle class with rising disposable incomes to consume and become an economic force.

Exhibit 4: GDP per capita (USD) of frontier markets, emerging markets, and developed markets

There are some 1.8 billion people with a median age of 26 in frontier markets. This compares with 3.6 billion in emerging markets with a median age of 32, and 0.9 billion in developed markets with a median age of 41 (United Nations, 2010). This favorable demographic profile in the frontier world is powerful because individuals tend to consume most between the ages of 16 and 40, a period when typically income levels rise, homes and families are built, and before consumers start more actively saving for retirement. As can be seen
in Exhibit 5, the median age in the frontier world is expected to breach 40 in 2055, as compared to 2035 in the emerging world (developed markets breached this age in 2010).

**Exhibit 5: Median age in frontier markets, emerging markets, and developed markets**

Many young people in frontier markets are eager to consume and may experience radical changes in spending patterns as they move from a very low income (defined as annual wages of less than USD1,000 per annum) to a lower-middle income (of between USD3,000 and USD5,000).

According to HSBC Global Economics’ estimates of overall spending, the proportion spent on food typically falls from more than 40% of total income at low income to around 10% at high income levels. Meanwhile, the type of food consumed materially changes, with the amount spent on meat, fish, and dairy increasing while non-protein staples such as cereals and vegetables play a smaller role in meeting calorific needs. Bad habits may also develop as they transition to upper middle income (USD5,000 to USD15,000 per annum), with, on average, a much larger proportion of income spent on consuming alcohol and tobacco (Ward & Neumann, 2012).

Between very low income and lower-middle income, rising levels of urbanization usually lead to more sophisticated accommodation. Individuals also tend to spend more on furnishings and appliances (for this reason, it is noteworthy that one of the world’s largest furniture retailer intends to open outlets in Qatar, Egypt, and Lithuania). This is followed by an increased spending on fuel to power appliances and provide heating and air conditioning. Furthermore, rising incomes also tend to accompany longer life expectancy; as salaries rise, consumers have spent more on health, social protection, insurance, and financial services.

Overall, this means that a much larger share of income might be spent on purchasing discretionary items. This includes clothing and footwear; housing and furniture; restaurants and hotels; recreation, culture, and gadgets; tourism and travel; and financial services.
3.4. Commodity wealth

Many frontier countries are naturally endowed with commodities and have been supported by the rise in commodity prices over recent years. Mongolia is an example of a country that has benefitted from export growth to nearby emerging markets like Russia and China. The country’s vast reserves of high quality coal, combined with its close proximity to China, make the country a growing strategic player in the global coal market. Mongolia is estimated to have potential coal reserves of 163 billion tons, according to the country’s Mineral Resources Authority (2010), most of which is yet to be developed (the Tavan Tolgoi “Five Hills” deposit in the South Gobi desert is reputed to one of the world’s largest untapped coking and thermal coal deposits).

Kazakhstan is another country that is richly endowed with natural resources, including oil and gas and a diverse range of mineral commodities. Kazakhstan is estimated to have nearly 30 billion barrels of proven oil reserves and, according to the IEA (2012), the country’s current oil production is dominated by two giant fields, both discovered in 1979, which produce about half of total output: Tengiz, located onshore northwestern Kazakhstan (and the world’s deepest operating giant field at 12,000 feet), and Karachaganak, also onshore northwestern Kazakhstan close to the Russian border. The offshore Kashagan and Kurmangazy oil fields, in Kazakhstan’s sector of the Caspian Sea, are estimated to contain at least 14 billion barrels, with Kashagan accounting for around 9 billion barrels. Kazakhstan is also the world’s largest producer of uranium, with approximately 33% of world production in 2010 (World Nuclear Association, 2013), which is the key ingredient in nuclear power generation and exported to countries such as the USA, Japan, and many countries within Europe. Furthermore, Kazakhstan is a large producer of chromium (16% of world output), titanium (11% of world output), cadmium (8% of world output), rhenium (5% of world output), and magnesium metal (3% of world output), and a significant producer of bauxite, copper, gallium, and zinc (US Geological Survey, 2012).

The prevalence of commodities in frontier markets has generated strong government credit positions. This allows governments to diversify their economies away from commodity production by investing in both hard infrastructure (e.g. roads, bridges, airports, seaports) and soft infrastructure (e.g. education, healthcare and other essential services) that will likely drive productivity growth over time. The State of Qatar is a classic example of this; in December 2010, the State won the bid to host the 2022 FIFA World Cup – the first Arab country to host the World Cup – as part of its long-term strategy to diversify its economy away from oil and gas. The State’s ambitious plans to host the event include the construction of nine new stadiums and the renovation of three existing ones, the addition of approximately 70,000 new hotel rooms, a national rail network and Doha metro, and a 25 mile (40km) bridge to Bahrain. Official estimates calculate the total cost of at least USD60 billion (around half of Qatar’s 2010 GDP).

Despite benefiting from the long-term trend in commodity prices, frontier stock markets are generally insulated from short-term commodity price movements. This is because commodity-producing companies, and oil producers in particular, tend to be government owned so they are typically unlisted. Examples include the world’s largest energy company (based on volumes of oil and natural gas produced), Saudi-owned, and the world’s third largest energy company, state-owned in Iran (Helman, 2012).

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4 China obtains approximately 70% of its energy needs from coal (largely for power and heat generation), thereby making it the world’s largest consumer of coal according to the US International Energy Agency (IEA, 2012).
3.5. Correlations

Global frontier markets have historically been amongst the least correlated to other equity classes, and lowly correlated with commodities for the aforementioned reason. Frontier markets can offer additional diversification as they have tended to have low correlations with each other (in other words, they have exhibited low cross-country correlations), as shown in Exhibit 6.

Exhibit 6: Frontier market correlations

These low correlations occurred because each market is driven by many different and often localized factors. Overall, these low correlations surprisingly result in lower volatility for the asset class. While it may sound counterintuitive, the volatility of global frontier markets has been consistently lower than emerging and developed markets over the last 5 years, as illustrated in Exhibit 7. It is important to note, however, that lower volatility generally only arises if a truly global approach is followed in order to reap these potential low cross-country correlation benefits5.

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5 There is no guarantee that these low correlations that drive low volatility for the asset class will continue in the future.
Exhibit 7: Annualized volatility of returns in frontier markets, emerging markets, and developed markets

Source: Bloomberg, data from September 2005 to June 2013. Past performance is no guarantee of future results.

3.6. Cash returns

Investing in global frontier markets can potentially provide investors with superior cash returns in the form of dividends, as evidenced by the dividend yields being generally higher in frontier markets than both developed and emerging markets over the period depicted in Exhibit 8.

Exhibit 8: Trailing dividend yields in frontier markets, emerging markets, and developed markets

12-month trailing dividend yield

Source: MSCI, Thomson Reuters DataStream, HSBC Calculations, 30 June 2013. Past performance is no guarantee of future results.


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This has been due to the fact that while the stock exchanges of frontier market countries may be relatively young, most companies themselves are not as they are typically well established, formerly government or family-owned businesses that are highly cash generative. For example, when the Cambodia Securities Exchange started trading in April 2012, the state-owned water utility company that was first established by royal decree in 1960, was the first company to be listed. The ongoing partial ownership by government or the founding entrepreneurs, as reflected in the average free float of frontier market companies being typically lower than those in emerging and developed markets, also influences a dividend policy that is biased towards returning cash to stockholders. The prevalence of high dividend payouts and dividend yields in frontier markets is further exacerbated by the dominance of local retail investors who, due to a lack of bank savings products and for cultural and behavioral finance reasons, often demand returns in the form of dividends.\(^6\)

### 3.7. Cheap valuations

At present, the valuation opportunity looks attractive, with frontier markets trading on cheap valuations both in absolute terms and relative to global emerging markets and developed markets, but with higher levels of return-on-equity as shown in Exhibit 9.

**Exhibit 9: Valuations and profitability of frontier markets, emerging markets, and developed markets**

**Valuations: 12-month trailing Price-to-Book**

**Profitability: Return-on-Equity**

Source: MSCI, Thomson Reuters DataStream, HSBC Global Asset Management, 30 June 2013. Past performance is no guarantee of future results.


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Over time, we expect investors’ knowledge and understanding of these markets to improve, liquidity to become deeper, and the markets to grow in size. As productivity growth and equity market returns in the mainstream emerging markets start to look less compelling, we expect investors’ attention to turn to frontier markets due to the “7Cs” characterizing frontier markets that, we believe, will drive some degree of convergence with emerging markets.

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\(^6\) There is no guarantee that these superior dividend yields will continue in the future.
4. Considerations: navigating the risks of global frontier markets

While the rationale for investing in global frontier markets is compelling, the potential for high returns does not come without some risk. Frontier markets are prone to a number of risks that need to be carefully considered and continuously navigated by investors in global frontier markets. These include political, commodity, liquidity, sector, and currency risks:

- **Political risks**
  
  Although many frontier market countries are far more stable than a decade ago, there will always be political risks that can unexpectedly diminish investors’ returns through outright or creeping expropriation or otherwise cause markets to close and disrupt investment activity. The expropriation of a Spanish oil and gas company’s controlling stake in an Argentine oil and gas company in 2012 is an example of the former, while the “Arab Spring” of 2011 which saw a wave of pro-democracy rebellions sweep across North Africa and the Middle East and resulted in disruption to investment activity is an instance of the latter.

- **Commodity risks**
  
  Some frontier countries, like Nigeria and the oil producing GCC states, and indeed some emerging markets like Russia for that matter, are sensitive to the oil price. However, in our opinion, the GCC states have amassed sufficient surpluses of wealth (being managed by their respective sovereign wealth funds) to resist most external shocks. In addition, as previously mentioned, frontier stock markets are generally insulated from short-term commodity price movements, as commodity-producing companies tend to be government owned and so are typically not listed on stock exchanges. This fact is reinforced by the low correlations of frontier markets with a range of commodities.

- **Liquidity risks**
  
  As many stock markets in frontier countries are in the process of developing, their free float and trading volumes are typically lower than those in emerging and developed markets and they are also often fraught with operational issues. These include trading restrictions, complex custodial arrangements, and poor regulation and enforcement. Indeed, trading legislation is sometimes non-existent or not properly enforced.

  While prudent risk management practices, combined with the reputation and bargaining power offered by a large bank-owned global investment manager, can help mitigate these operational concerns, illiquidity is an issue common to all investment managers and requires a strict and disciplined focus on investing in truly liquid stocks. A strict focus on liquidity means that frontier markets equity strategies are invariably limited in capacity although as frontier markets evolve and mature, volumes and liquidity will likely increase as will the capacity of dedicated frontier market equity strategies.

- **Sector risks**
  
  Sector exposures can be more pronounced in frontier markets since the three largest sectors in our custom benchmark – financials, industrials, and energy – represent approximately 46%, 14%, and 9% respectively (69% in total), as at June 2013. While the financial sector may appear to be significant, it is congruent with the way in which stock exchanges typically develop. Specifically, when governments decide to establish a stock exchange, the key state-owned corporations – usually the banks, telecoms, and utilities – are the only candidates available for listing within the direct control of the state.
Notwithstanding the obvious benchmark bias towards banks in frontier markets, we are generally comfortable owning such stocks as the banks tend to mirror the local economy and can be an ideal way of tapping into domestic credit growth and, by extension, productivity (and indeed GDP) growth. Banking in these countries is also characterized by an “old fashioned” approach, where banks typically generate a healthy net interest margin by simply taking in deposits at low interest rates and making loans at higher rates of interest. Given this simplicity in their product offerings, combined with the localized nature of banking activity, banks in frontier markets have generally been sheltered from the systemic risk associated with global banking systems.

As the frontier markets evolve and a more diverse range of companies list on local exchanges, the bias to financials will likely diminish. We believe energy and telecoms are generally well-positioned industries that can benefit from technologies that have been tried and tested in the developed world. In Kenya, for example, developments in mobile telephony have enabled a local company to offer “leapfrogging innovation” to customers in the form of mobile banking. In particular, the company developed and launched a mobile phone based payment system in 2007 that enables its fourteen million subscribers (representing over 30% of the population) to transfer money without the need for a bank account via SMS. This is especially important in a society where the vast majority of people do not have bank accounts.

- Currency risks

In comparison to mainstream emerging market currencies, frontier market currencies generally have less liquid and deep foreign exchange markets. Wider bid-ask spreads, larger commissions, higher currency volatility and even restrictive regulations tend to define these markets. However, many frontier market currencies are undervalued on a Purchasing Power Parity (PPP) basis, even when accounting for the “Penn effect” (a PPP-deviation due to the fact that baskets of goods are cheaper in low-income countries than in high-income countries), as shown in Exhibit 10. Given this undervaluation, they are likely to appreciate over the medium to long term.
Based on this chart, almost all frontier market currencies can be seen as significantly undervalued on a raw PPP basis, with the Bahraini Dinar, Tunisian Dinar, and Vietnamese Dong close to being 60% undervalued. The UAE Dirham is the notable overvalued currency. Even when adjusting these raw PPP valuations for the Penn Effect, the vast majority of currencies remain undervalued. Nevertheless, in order to potentially benefit from these undervalued currencies, investors may have to ride out short-term volatility.

While some of these risks are within the control of investment managers, such as the degree of illiquidity one is willing to bear for potential incremental returns, political risks are outside investors’ control and it is precisely for this reason that we believe a globally diversified approach with sensible regional and country allocations is essential for prudent investing. Moreover, as stated by Warren Buffet, “risk comes from not knowing what you’re doing”, so we believe that it is particularly important for investors to outsource their frontier market allocations to investment managers with a dedicated team of experienced frontier market portfolio managers who can tap into vast on-the-ground resources across disparate frontier countries.
5. Capital Allocations to Frontier Markets

Investing in global frontier markets can be a logical next step for forward-thinking investors with an incumbent allocation to emerging markets. It can enable them to broaden out their emerging markets allocation to countries they may not otherwise have exposure to and allow them to participate in the potential productivity growth associated with pre-emerging markets that may drive superior returns over the medium to long term.

We believe the best way to access the ‘alpha’ opportunity afforded by these highly inefficient markets is through a strategic allocation to global frontier market equities. Although some global emerging market managers may have the discretion to invest in frontier market equities as part of an emerging market mandate, dabbling in frontier markets from time to time may not harness their full potential, particularly if investment is limited to the most liquid frontier market stocks or countries. Furthermore, it can deny investors the considerable potential diversification benefits offered by global frontier markets.

As previously mentioned, global frontier markets have historically been among the least correlated to other equity classes globally, and lowly correlated with individual constituent countries, thereby making them historically less volatile than emerging markets. This is appealing from an asset allocation perspective as it provides investors with an opportunity to potentially improve the risk/return profile of their portfolios. This is illustrated in the efficient frontier depicted in Exhibit 11 which, based on the assumptions made (higher expected real returns in global frontier markets than emerging markets due to anticipated currency gains and lower risk for the reasons already outlined), shows that substituting a portion of a global emerging markets allocation with global frontier markets could incrementally reduce volatility and enhance potential returns for investors:

Exhibit 11: Efficient Frontier showing the incremental benefits of substituting global emerging markets with frontier markets

Source: HSBC Global Asset Management. For illustration purposes only. Assumptions: EM real return of 6.0%, EM volatility of 25.0% / FM real return of 7.0%, FM volatility of 22.0% / Correlation of FM with EM = 0.65. The results along the efficient frontier are those of various hypothetical portfolios and do not represent any HSBC strategy or product. Hypothetical results are provided for illustrative purposes only and are no guarantee of future results. The results do not include the impact of fees, which would lower the returns. No representation is being made that any portfolio has achieved, or will likely achieve the results shown. Any changes to the allocation and assumptions could have a material impact on the results. Hypothetical examples have many inherent limitations and are generally prepared with the benefit of hindsight. In addition, there can be sharp differences between hypothetical results and actual results. Keep in mind, factors related to the markets in general or the implementation of any specific investment strategy, which cannot be fully accounted for in the preparation of hypothetical results, can adversely affect actual results. Past performance is no guarantee of future results. In addition, asset allocation and diversification does not protect you against a loss in a particular market; however it allows you to spread that risk across various asset classes.

Given the infancy of the frontier markets asset class, with an estimated USD15 billion in assets under management in dedicated frontier market funds versus some USD880 billion in emerging markets funds according to Citi (Howell & Gratsova, 2011), it will naturally take some time for most investors to overcome their preconceptions of many frontier countries and embrace the potential benefits of allocating to frontier markets on a global basis.
6. Conclusion

Investor interest in global frontier markets – those countries that are pre-emerging or ‘verging on emerging’ – is surging due to the “7Cs” that characterize the asset class. These “7Cs” include:

1. A comprehensive universe of some 3,000+ stocks across 60+ countries that are highly inefficient;
2. Change or relative improvements over time that we expect to reduce institutional voids and thereby drive rapid productivity (and hence GDP) growth;
3. A large, young, and growing base of consumers who are hungry for aspirational goods and services;
4. Commodity wealth resulting in strong government credit positions which enables infrastructure spending and, where relevant, industrial diversification away from commodity production;
5. Correlations that have been historically low with other equity asset classes, constituent frontier market countries, and commodities which has resulted in surprisingly low asset class volatility;
6. Cash returns in the form of high dividend yields given the cash flow generative nature of established frontier market companies that are simply new to the local stock exchange; and
7. Cheap valuations, both relative to emerging and developed markets and against their own history.

Collectively, these “7Cs” could potentially drive superior investment returns to emerging and developed markets through high dividends, capital gains, and currency appreciation for those early adopters of the global frontier markets asset class. Of course, the potential for high returns does not come without some risk and frontier markets can be prone to political, commodity, liquidity, sector, and currency risks, which is another reason for diversifying globally across many frontier countries.

We believe the best way to access the ‘alpha’ opportunity afforded by these highly inefficient markets is through a dedicated strategic allocation to global frontier market equities. Although some global emerging market managers have the discretion to invest in frontier equities as part of their emerging market mandate, dabbling in frontier markets from time to time fails to harness the full potential. In particular, since global frontier markets have historically been among the least correlated to other equity classes, and lowly correlated with individual constituent countries, they have been less volatile than mainstream emerging markets. This is appealing from an asset allocation perspective as it can provide investors with an opportunity to potentially improve the risk/return profile of their overall emerging market portfolios and any allocation to global frontier markets above zero – the current allocation level for most investors – we believe can provide meaningful diversification benefits in the form of reduced portfolio volatility and enhanced potential returns.

For those forward-thinking investors willing to start building a dedicated allocation to global frontier markets now as a natural extension of their incumbent global emerging market allocation, not only could they potentially benefit from an improved risk/return profile within their emerging market portfolios but they may also profit from increasing flows into the asset class as these markets become a more popular investment destination for the conventional investor community.

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7. Citations


Non-diversification.

Exposure to commodities markets, including investments in specific commodities such as precious metals, may subject a strategy to greater volatility than investments in traditional securities. The value of commodity-related investments may be affected by overall market movements and factors specific to a particular commodity.

Risk Considerations. There is no assurance that a portfolio will achieve its investment objective. In addition, there is no guarantee that any investment strategy will work under all market conditions, and each investor should evaluate their ability to invest for the long-term, especially during periods of downturn in the market. Portfolios are subject to market risk, which is the possibility that the market values of securities owned by the portfolio will decline. Accordingly, you can lose money investing. The strategy may be subject to certain additional risks, which should be considered carefully along with the strategy’s investment objective and fees before investing. Equity. In general equity securities’ values also fluctuate in response to activities specific to a company. Foreign and emerging markets. Investments in foreign markets entail special risks such as currency, political, economic, and market risks. The risks of investing in emerging-market countries are greater than the risks generally associated with foreign investments. Derivative instruments. Derivatives can be illiquid, may disproportionately increase losses and may have a potentially large negative impact on extreme price volatility and illiquidity in frontier markets; government ownership or control of parts of private sector and of market countries are magnified in frontier market countries. The magnification of risks are the result of: the potential for or legal and political systems than traditional emerging market countries. As a result, the risks of investing in emerging-market countries are greater than the risks generally associated with foreign investments. Sector concentration. When a strategy will invest more than 25% of its total assets in securities issued by companies in the financial services group of industries. Accordingly, a strategy will be more susceptible to developments that affect such industries, such as economic cycles, interest rate changes, business developments and regulatory changes, than other strategies that do not concentrate their investments. Commodity-related investments. Exposure to commodities markets, including investments in companies in commodity-related industries, may subject a strategy to greater volatility than investments in traditional securities. The value of commodity-related investments may be affected by overall market movements and factors specific to a particular industry or commodity.
Benchmark definitions. These indices are presented to provide you with an understanding of their historic long-term performance, and are not presented to illustrate the performance of any security or trading strategy. Indices are unmanaged and are not subject to fees and expenses typically associated with managed accounts or investment funds. Investments cannot be made directly in an index.

The Morgan Stanley Capital International (MSCI) World Index is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed markets. The MSCI Emerging Markets Index ("MSCI EM") is a free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets. The MSCI Frontier Markets Index ("MSCI FM") is a free float-adjusted market capitalization index that is designed to measure equity market performance of frontier markets. The MSCI Saudi Arabia Index is currently not included in the MSCI Frontier Markets Index but is part of the MSCI Gulf Cooperation Council (GCC) Countries Index. The MSCI Bosnia Herzegovina Index, the MSCI Botswana Index, the MSCI Ghana Index, the MSCI Jamaica Index, MSCI Trinidad & Tobago and the MSCI Zimbabwe Index are currently stand-alone country indices and are not included in the MSCI Frontier Markets Index. The addition of these country indices to the MSCI Frontier Markets Index is under consideration.

Any performance information shown refers to the past and should not be seen as an indication of future returns.

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