

# FRONTIER EMERGING MARKETS

## THE REFORM STORY

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Frontier Emerging markets conjure a picture of underdeveloped third world countries where investors are subject to risks that cannot be easily understood. In this paper we will explore these inherent prejudices and biases and try to show that in a diversified portfolio, the risks of Frontier Emerging Market investing may actually be lower than other equity asset classes and the potential returns greater.

### The Frontier World

There are currently 195 countries in the world of which approximately 51 are classified by the major equity index providers as Developed or Emerging Markets. The rest of the countries are, by exclusion, Frontier. This universe includes a very wide range of countries at varying stages of political, economic and stockmarket development. This 144 country Frontier grouping is where we predominantly look for investment opportunities. The single key attribute that we are looking for before considering the companies in any country as an investment opportunity is reform. In our near 30-year history of Emerging Market investing, we have found a one-to-one correlation between political and economic reform, and economic growth. Conversely we look to avoid completely countries that are experiencing a negative reform process as we have found this will generally lead to serious economic issues which most of the time will overpower the ability of even the most competent companies to grow.

### The Reform Process

There are many recent examples of countries that have experienced very strong economic growth due to firstly a change of political regime, and secondly the subsequent implementation of reformist, market orientated economic policies. The end of the communist regimes in Eastern Europe was certainly a major reform catalyst, however we have seen massive differences in the political and economic regimes to subsequently emerge from the region. For example Romania struggled under a burden of political corruption and cronyism for the first 20 years of its post-communist life, until an anti-corruption and economic reformist administration turned it into the fastest growing country in the whole of Europe over the last four years. Pakistan emerged from a military dictatorship in 2013 and the new reformist and extremely business orientated government has, through the implementation of sensible economic policies, turned the country into one of the fastest growing in Asia. Argentina has had a similar transformation following the new Macri government coming to power in 2015.

Against these positive transformations can be set many examples of negative reform processes that are, again, highly correlated with a contracting economy. Whether it be Nigerian economic mismanagement or the return or emergence of dictators in places like Zimbabwe or Venezuela, one of the strengths of our investment style and process is that we are able to exit or completely ignore these countries whilst these regimes persist.

In terms of the actual reforms themselves, most of these

Frontier countries that we do consider actionable investment opportunities today have previously been managed by a political regime that was not conducive to capitalism, leading to predominantly short term, populist economic policies that ultimately were not able to persist. The reforms that are required are normally therefore predictable due to being repeated many times over the years in many countries throughout the world. Liberalisation of the exchange rate, removal of fuel and electricity subsidies, independence of the central bank, privatisation and taxation are a few of the major reform areas that tend to be at the front of the new policies queue. A sustainable reform process will then move on to issues such as strength and independence of institutions like the judiciary, land law reform and stock market reform, all of which should continue to drive economic growth.

### Finding the Right Companies

From our basic philosophy for investing in these countries that reforms create economic growth, the rest of our investment process is about finding companies that can benefit from this growth. We are looking for strong management with a track record of business execution in these countries and we spend a long time making sure that the corporate governance of the company allows us, as minority shareholders, to benefit from the results. Our focus is therefore on domestic companies and we research many sectors to determine, for each country, which companies have the most constructive business environments created by the reforms that are specific to the structures of each economy. As with every country globally, each have their own specific advantages whether they be resource based, geographical or cultural. Sector examples in different countries where we have found some of our most successful investments include cement in Pakistan, electrical utilities in Argentina, banks in Georgia and healthcare in UAE.

### Risk and Return

The focus on domestic political regime change driving our investment process creates some unique benefits to Frontier Emerging Markets investing from a risk and a return perspective.

Firstly, from a risk perspective, stockmarket correlation levels between Frontier Markets and Emerging or Developed Markets have tended to be extremely low, between 0.3 and 0.4 since 2010. One significant reason is the very low levels of government, corporate and household debt in these countries, due mainly to the unavailability and cost of debt under the previous non market friendly regimes. This has made the

Frontier universe very unsusceptible to movements in global currencies or interest rates. Connected to this factor is the very low level of foreign ownership of equities and bonds in these markets which has limited correlation to global events.

Low correlation to global markets is also substantially aided by the main drivers of these economies being domestic political and economic factors. The greatest impacts on economic growth in most of these markets come from the positive or negative reform processes and these countries are therefore very isolated from each other. For example a negative regime change in Argentina would have no impact on the political or economic prospects for Pakistan. It is quite common to find negative correlations between any two Frontier stock markets.

Looking at the return side, forecast economic growth rates in Frontier markets overall, are substantially higher than in Emerging or developed markets. When we just focus on those countries with the most progressive reforms, this differential increases substantially. Our investment process is designed to convert this economic growth into sustainable company earnings growth, again rates that are potentially much greater than occur in Developed or Emerging Markets.

The other significant reason why these country and company opportunities exist is the very low levels of research in Frontier countries and on Frontier companies. We believe our ability to understand how a reform process impacts different sectors and companies, and at what speed, from our long history of similar situations, allows us to get ahead of the market in terms of our corporate earnings assumptions. The lack of quality, or in some cases any, research enables us to uncover, by constructing our own company financial models, what we believe to be significant alpha opportunities. Due to this lack of research focus and the limited international focus on these companies,

most importantly we have been able to buy companies often at very cheap valuations.

### Conclusion

In our near 30 year experience of these markets we have seen many countries around the globe emerge from international political or economic isolation to become significant investment destinations, and we have seen many move in the opposite direction. We believe the ability to understand the early signals of a negative reform process, and our understanding of a positive process and its effects on companies allows us to generate superior portfolio returns over the long term. There are no new economic or political systems, we just have to understand which of the examples from our experience is being played out this time. Continually updating our knowledge through extensive travelling, and the ability to keep an open mind to new opportunities, will continue to drive our process.

Dominic Bokor-Ingram  
Frontier Emerging Markets Portfolio Manager

Address: 39 St James's Street, London SW1A 1JD

Tel: + 44 (0)20 7518 2100

Fax: + 44 (0)20 7518 2199

Email: [marketing@charlemagnecapital.com](mailto:marketing@charlemagnecapital.com)

Website: [www.charlemagnecapital.com](http://www.charlemagnecapital.com)

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