MARKET INSIGHT

July 2015

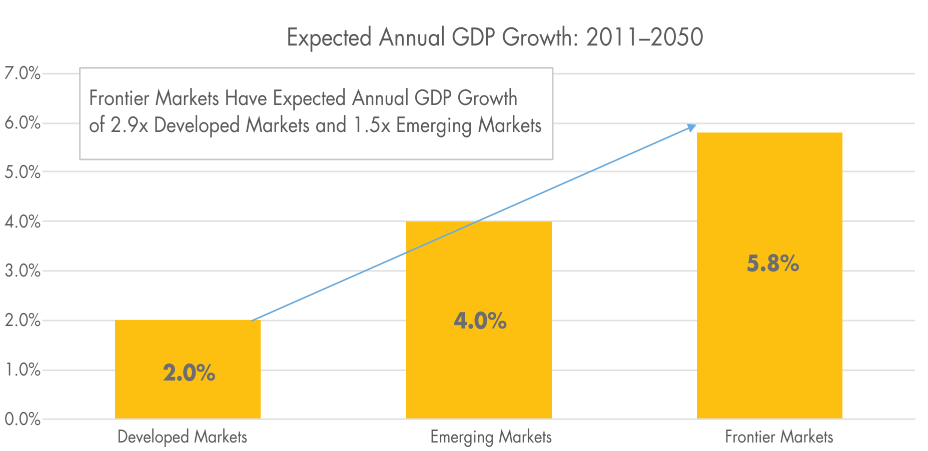
THE NEXT FRONTIER OF INVESTING?

INTRODUCTION

In investing parlance, the Developed Economies, which cover 90% of the global equity investment opportunity set, are represented by the U.S., Europe, United Kingdom, Japan and other major economies. These are high-income countries with liquid and well established capital markets. Next, there are the Emerging Markets which represent approximately 10% of global equities, and are dominated by China, Brazil, India and Russia. These markets can be defined as middle and lower income countries with relatively liquid and investable capital markets. The next generation of emerging markets are called Frontier Markets, which are primarily African, Middle Eastern and former USSR countries and represent about 0.2% of the total global equity investment opportunity set. These are primarily characterized as lower income countries in which financial markets exist, but are not relatively liquid or investable (Gratsova, 2013).

For many years, Developed Economies have attracted capital due to their greater GDP per Capita and a high return on invested capital. However, many of these economies are still recovering from the impact of the Global Financial Crisis of 2008. Since then, the real economies have been stuck in a low growth, low productivity quagmire that is well below what was experienced the last 20 years. According to the International Monetary Fund's ("IMF") latest World Economic Outlook (Blagrave, et al., 2015), trends in demographics and productivity in this decade are expected to deliver on average only 1.6% economic growth per year in the Developed Economies. This compares to 2.5% in the late 90's. Conversely, as Figure 1 illustrates, the Frontier Markets are expected to deliver much higher growth than both the Developed and the Emerging Markets. That potential growth led us to question if we should be investing in the Frontier Markets.

FIGURE 1



SOURCE: CITI INVESTMENT RESEARCH AND ANALYSIS; HIGHLAND ASSOCIATES

OVERVIEW

·Frontier markets are expected to experience much higher economic growth than both the Developed and the Emerging Markets due to their favorable demographics, cheap labor and a move towards a more market-oriented environment.

·Frontier markets are highly concentrated by industry and country exposure.

·Frontier markets have low liquidity due to their smaller financial markets and difficulty accessing invested capital.

INVESTING FOR THE TOTAL CLIENT

- *Investment services*
- *Reporting services*
- *Business services*

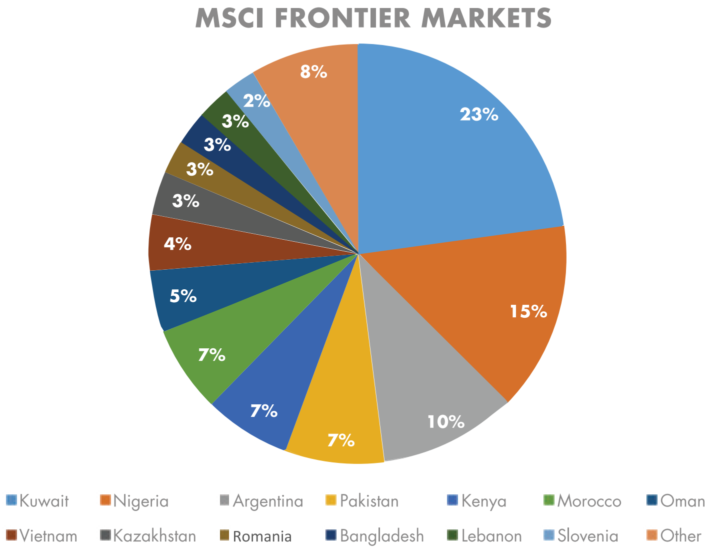
OPPORTUNITIES
WHY ARE THE FRONTIER MARKETS EXPECTED TO SEE SUCH GROWTH?

The Frontier Markets (See Figure 2) can be characterized as countries that are:

- small and wealthy, but have onerous restrictions on foreign capital (as seen most commonly in Middle Eastern countries)
- large and poor (primarily in Africa and Southeast Asia).

The countries that investors are most excited about and have the highest growth potential are the latter.

FIGURE 2



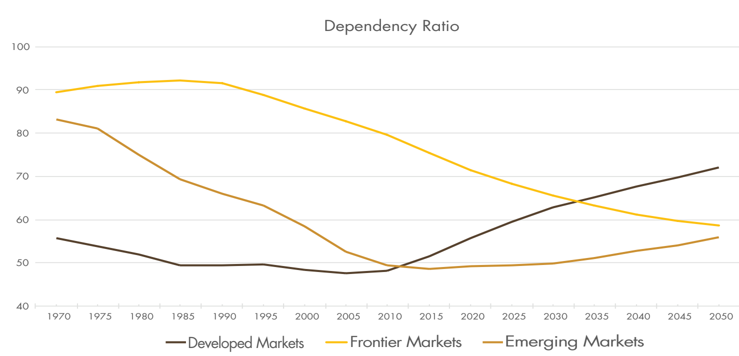
SOURCE: MSCI; HIGHLAND ASSOCIATES; "OTHER" IS COMPRISED OF SRI LANKA, CROATIA, MAURITIUS, BAHRAIN, JORDAN, TUNISIA, ESTONIA, SERBIA, LITHUANIA, BULGARIA, UKRAINE

Approximately 1.6 billion people live in the Frontier Markets, which accounts for almost a quarter of the world's population, but only 6% of the world's GDP growth (E&Y, 2013). Investors and companies are looking at these growing markets and seeing that they are underpenetrated with a massive number of potential consumers and cheap labor. In fact, according to a recent article in the *Wall Street Journal*, Africa now receives more foreign direct investment than foreign aid (Stevis, 2014).The Frontier Markets are poised for stronger growth because they are launching from a low level of current income, have favorable demographics and abundant natural resources. For many countries, policies are being implemented that will lead to more market liberalization, and thus an increase in equity opportunities.

To get an idea of how impoverished these countries are, if we exclude Kuwait, which is one of the wealthiest countries in the world (and is only a Frontier Market due to its foreign ownership restrictions), then the median GDP per capita of the seven largest Frontier Markets is $4,012 which compares to a median GDP per capita of $37,307 for the G-7 countries (USA, UK, Japan, Germany, France, Italy, Canada, Germany). Because of this low base, even a modest improvement in GDP translates into substantive gains in the Frontier Market economies. It doesn't take much improvement to see some real gains in these local economies.

The next catalyst for the Frontier Markets is their desirable demographic profile. Although there are many factors that can drive economic expansion, having higher population growth has historically been a good harbinger for future growth. According to Citi (Howell & Gratsova, 2011), annual population growth in the Frontier Markets is 1.6% which compares to 0.9% in Emerging Markets and 0.4% in Developed Markets. Further, not only is the population growing faster, but the working age population is also more promising. Figure 3 below from the United Nations looks at the dependency ratio, which is the number of people not in the work force (i.e. the young and the old) divided by the number of people in the work force. As the dependency ratio declines, then a higher amount of the population is of working age and thus at their peak productivity years. As Figure 3 demonstrates, the Developed Markets' dependency ratio is beginning to rise and will cross paths with the Frontier Markets in the next twenty-five years. Why is this long-term trend important to investors? A younger workforce has a higher savings rate, and the higher the savings rate, the more capital that is available in the form of loanable funds for firms to use for investment. This investment leads to new capital in the economy and increases the country's productivity (ultimately driving up GDP per capita).

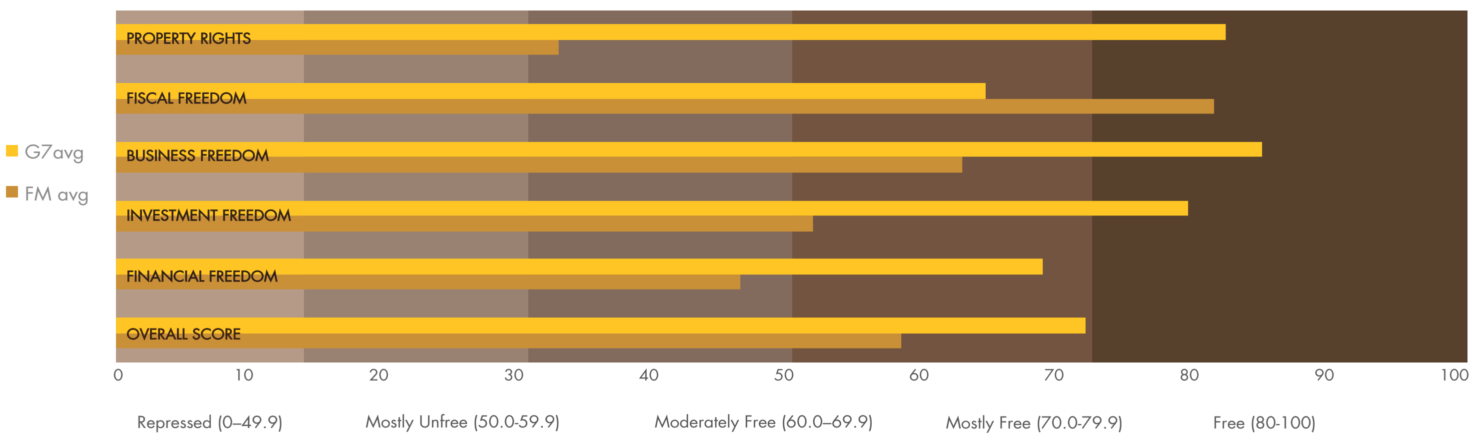
FIGURE 3



SOURCE: UNITED NATIONS; HIGHLAND ASSOCIATES

To understand what happens when population falls, consider Japan the last 10 years. Between 2005 and 2015, Japan's working-age population fell by an estimated 7.7 million people, while its elderly population grew by more than 8 million (Minnich, 2015). During the same period, the household savings rate collapsed, and social security emerged as the single largest government expenditure, followed closely by debt-servicing payments — a result of Japan's deepening budget deficits and mounting sovereign debt. In this ten year period, Japan has experienced annualized GDP growth of only 0.6%. Unfortunately, this is not just an isolated issue in Japan. Many European countries are also experiencing large increases in their dependency ratio. Since 1980, the three largest European countries, Germany, United Kingdom and France have seen a steady increase in their dependency ratios.

FIGURE 4



SOURCE: HERITAGE FOUNDATION; HIGHER SCORES INDICATE A HIGHER LEVEL OF FREEDOM FOR EACH FACTOR

Historically, investors have done well investing in countries that were expected to experience strong economic growth and had favorable demographics. Examples of this would have been investing in Japan in the 1970's (20% annualized return from 1970-1990) or China in the mid 1990's (20% annualized return from 1995-2007). The Frontier Markets could be poised to also deliver exceptional equity market gains.

THREATS

WHAT ARE THE POSSIBLE RISKS OF INVESTING IN FRONTIER MARKETS?

After discussing the potential benefits of investing in the Frontier Markets, we must also look at the risks they pose. The Frontier Markets are characterized by low liquidity and small market capitalization. This is very important to us as potential investors. A lack of liquidity causes realized gains to be less than those implied by the market. This is because upon sale of an equity position, if there is no ready buyer to purchase the asset from you at the market price, then you may have to sell at a discount to that market price. With a multitude of buyers, you are more likely to realize the market price and the expected gains on your position. As an example of low liquidity markets, Nigeria and Kenya are two of the largest countries in the Frontier Markets, and their average daily trading volume is only $25 million and $8 million, respectively*. In comparison, the average daily trading volume for McDonald's and Apple are $688 million and $6.5 billion, respectively**.

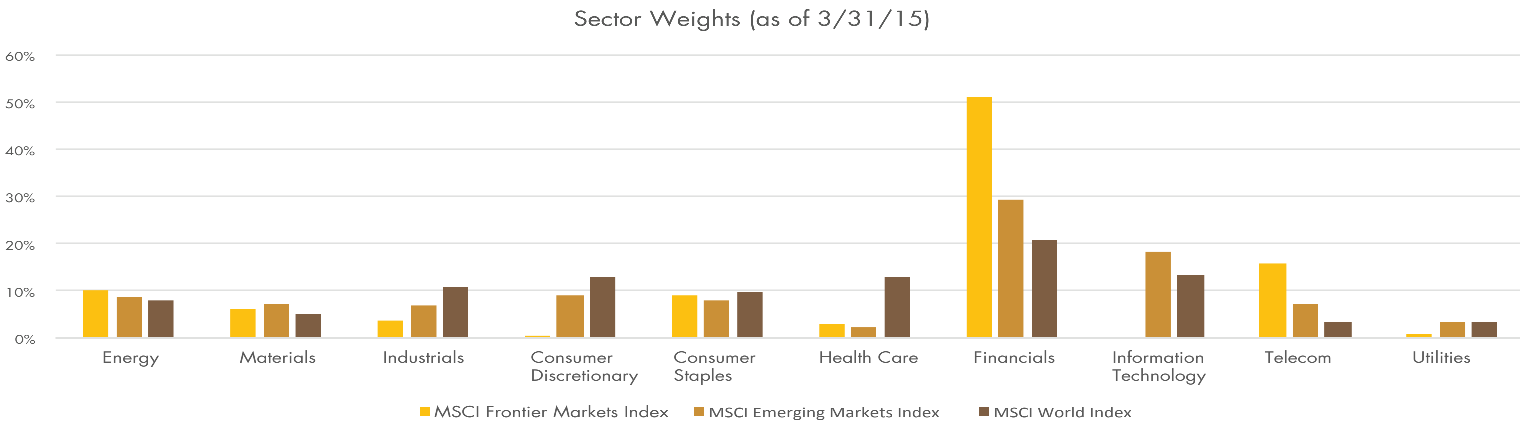
Another major risk of investing in Frontier Markets is political and economic instability. In order to quantify the Frontier Markets stability, we utilized the Heritage Foundations' Index of Economic Freedom. We then focused on the factors that are most important to us as potential investors, which include the Rule of Law, Regulatory Efficiency, and Freedom of the Markets. Figure 4 compares the Frontier Markets to the G-7 countries and provides an overall score. As the chart illustrates, the Frontier Markets score very low on Financial Freedom, Investment Freedom and Property Rights. When investing in markets that have historically experienced an increased level of geopolitical turmoil, a lack of legal and regulatory protection to potential investors is of even greater concern.

An additional risk stems from the composition of the index. There are sector and position concentrations that are cause for concern. Figure 5 provides a snapshot of the MSCI Frontier Market by Sector as compared to the MSCI Emerging Markets and the MSCI World (which includes the largest developed economies in the world). The largest sector by far in the Frontier Markets is

*The Nigerian Stock Exchange as of December 31, 2014

**FactSet as of May 1, 2015

FIGURE 5



SOURCE: MSCI; HIGHLAND ASSOCIATES

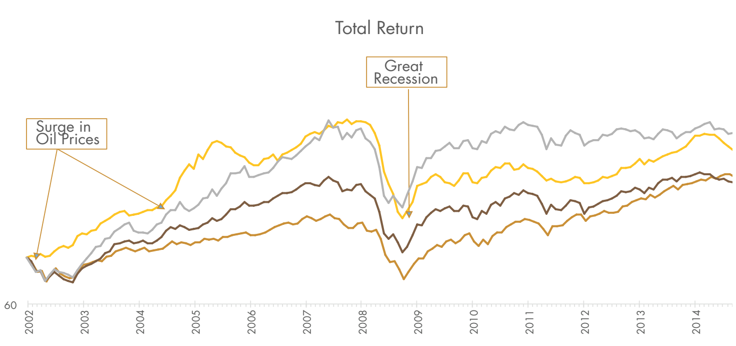
Financials which comprises 51% of the index. Although Energy only accounts for 10% of the index, many of the Frontier Market countries are commodity exporters and are particularly sensitive to the price of oil. During the recent decline in oil prices, Frontier Markets substantially underperformed Developed Markets, which are primarily oil importers and benefited from the fall in oil prices. Further, the Top 10 constituents of the MSCI Frontier Markets index comprise 34% of the index, with three individual names making up 19% of the index. As a point of comparison, the top 10 constituents of the MSCI World amount to 9% of the index.

PORTFOLIO IMPLICATIONS

HOW HAS THE ASSET CLASS PERFORMED?

As for performance, Figure 6 compares the Frontier Markets (gold) with U.S. (tan), Developed International excluding U.S. (brown) and Emerging Markets (grey) since its inception in May 2002. Although the Frontier Markets outperformed both Developed Markets, the graph is a bit misleading. First, notice how the Frontier Markets rose beginning in 2002, while the other three

FIGURE 6



SOURCE: FACTSET, SINCE MSCI FRONTIER MARKETS INDEX INCEPTION (MAY 2002-MARCH 2015)

markets declined almost 24% on average. In 2002, crude oil rose 51%, benefitting almost three quarters of the Frontier Markets Index, which was comprised of Kuwait, Qatar and the United Arab Emirates. (The latter two countries were removed from the Frontier Markets Index and promoted to the Emerging Markets Index in 2014.)

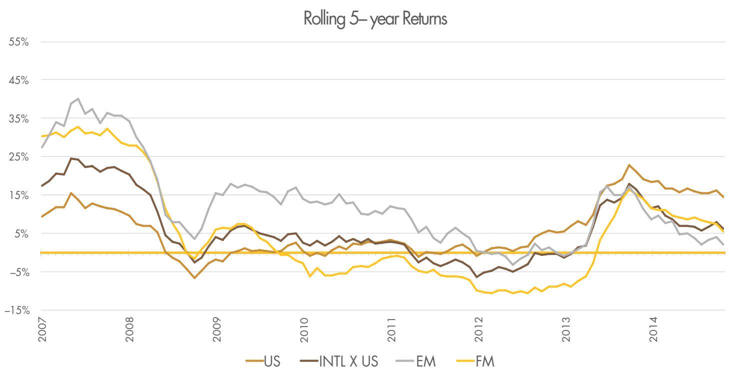
In 2005, the Frontier Markets again outperformed the other three markets, as the Middle Eastern countries benefited from oil price gains of 44%. Frontier Markets increased 72%, while the other three markets were up 21% on average.

During the biggest market decline of the period in 2008, the Frontier Markets experienced a 67% peak-to-trough drawdown, while the U.S. and International ex. US markets incurred drawdowns of 49% and 54%, respectively. This reinforces the importance of liquidity during times of distress. We would expect Frontier Markets to have persistently higher drawdowns during future market dislocations. In order to understand how detrimental a drawdown of that magnitude can be to your portfolio, we looked at rolling 5-year returns for all of these markets. The Frontier Markets (grey) have had negative rolling 5-year returns for almost half of their time since inception (see Figure 7).

When investing in international equity markets, total investment returns are determined by the dividend yield, earnings growth, change in valuation, and change in exchange rates. As a U.S.-domiciled investor, returns in international markets benefit when the dollar weakens and suffer when the dollar strengthens.

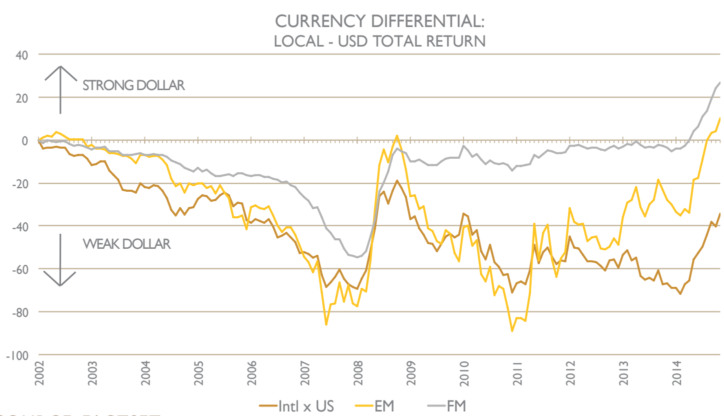
Figure 8 illustrates how this can impact your returns and is de-

FIGURE 7



SOURCE: FACTSET; HIGHLAND ASSOCIATES

FIGURE 8



SOURCE: FACTSET

signed to illustrate the compounding effects of the movement in the U.S. dollar versus other currencies. The move in the U.S. dollar is negatively correlated with total returns. For example, from 2002 through 2008, the U.S. dollar weakened considerably increasing total returns in International ex U.S., Emerging and Frontier Markets in U.S. dollar terms. However, since 2011, the U.S. dollar has strengthened, which has negatively impacted total returns in U.S. dollar terms.

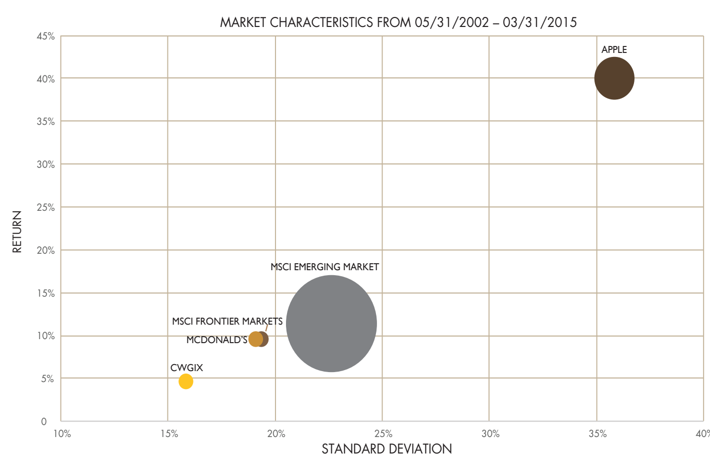
The other point worth noting about the currency impact in Frontier Markets is that some of these countries peg their currency to the U.S. dollar, which means their currency floats with the dollar. However, as we recently observed with the Nigerian Naira, these pegs are subject to change. Nigeria's economy is significantly impacted by the price of oil (according to Bloomberg, oil and natural gas account for at least 85% of their exports), and thus when oil prices fell in late 2014, the country suffered from lower export earnings. In order to boost exports, the Central Bank of Nigeria devalued the Naira from $0.0065/1N to $0.0060/1N in November 2014, and then to $0.0050/1N in February 2015. With many of these countries, the dollar peg can only be relied upon in optimal situations, not in times of distress.

Figure 9 compares the risk versus return of the MSCI Frontier Markets to the MSCI Emerging Markets, McDonald's, Apple, and the American Funds Capital Growth and World Income Fund ("CWGIX"). The market capitalization of each is represented by the size of their bubble. The main point to note is that the size of the MSCI Frontier Markets Index, which stands at $92 billion as of March 31, 2015, is approximately the same size as McDonald's, slightly smaller than CWGIX, and dwarfed by the MSCI Emerging Markets which stands at $3.8 trillion. By investing in McDonald's, a company that has placed an added emphasis on expanding in Frontier Markets, investors would be able to:

1. access a similar sized market cap,
2. experience lower volatility,
3. experience similar returns,
4. have increased liquidity,
5. have lower currency risks,
6. have lower geopolitical risks.

Another point worth noting is that the Frontier Markets have lower volatility than the Emerging Markets. Figure 10 illustrates that Frontier Markets have a low correlation with developed and emerging markets. Investors looking for long-term growth with low market correlation are surveying the Frontier Markets as a source of diversification. We believe correlations are lower because Frontier Markets have more country specific risks than the Developed and Emerging Markets. For example, performance in the Emerging Markets has been driven by China and its significant growth the last 20 years. As China grew and consequently required more resources, countries like Brazil thrived as they ex-

FIGURE 9



SOURCE: MSCI; FACTSET; HIGHLAND ASSOCIATES ported more goods and commodities to China. In fact, the average intra-country correlation among MSCI Emerging Markets is 0.56, which is significantly greater than the intra-country correlation of MSCI Frontier Markets at 0.26.

ARE VALUATIONS ATTRACTIVE?

FIGURE 10

Description	MSCI FM	MSCI EM	INTL EX US	S&P 500
MSCI FM	1.00	0.58	0.62	0.54
MSCI EM	0.58	1.00	0.89	0.79
INTL EX US	0.62	0.89	1.00	0.89
S&P 500	0.54	0.79	0.89	1.00
Avg Intra-country/company	0.26	0.56		

SOURCE: MSCI; FACTSET; HIGHLAND ASSOCIATES; TIME PERIOD: MAY 2002 – MARCH 2015

The Frontier Markets have cheaper valuations and higher dividend yields than the other markets (see Figure 11). The higher dividend yield is primarily related to the sector weighting of the Frontier Markets, where Financials, which have a higher dividend yield than most sectors, comprises half of the index. In addition, for cultural and religious reasons, dividend payments are attractive for local investors, particularly in the Middle East where Islam is the dominant religion. Under Sharia law, usury or the charging of interest on loaned funds is prohibited. This makes bonds a non-investable asset for many Islamic investors. For investors seeking income, high dividend yielding stocks are most attractive.

Taking a deeper dive into Price-to-Earnings ("P/E") and Price-to-Book ("P/B"), Frontier Markets have historically traded on average at a 12.4x P/E multiple and 1.6x P/B multiple. Currently, Frontier Markets are trading at a 10% discount to their historical average for P/E and in-line with P/B. Interestingly, on a P/E valuation, Frontier Markets are trading only slightly above where they were trading in mid-2011. According to Morningstar (Oey, 2014), Frontier Market funds have seen inflows of $4 billion in the last 3 years. With this in mind, flows of capital do not appear to have been a major driver of returns as we would have expected the P/E multiple to expand more if that was the case. Further, valuations surged in mid-2013. This is when MSCI announced that Qatar

FIGURE 11

MARKET	PRICE TO EARNINGS	PRICE TO BOOK	DIVIDEND YIELD
S&P 500	17.1X	2.8X	1.9%
INTL EX US	18.4X	1.8X	2.9%
EMERGING MARKETS	13.7X	1.6X	2.6%
FRONTIER MARKETS	11.1X	1.6X	4.1%

SOURCE: FACTSET; HIGHLAND ASSOCIATES; AS OF MARCH 31, 2015

and United Arab Emirates would be moving up to the Emerging Markets Index in June 2014. Therefore, this upswing in valuations was most likely due to investors front-running the index change as well as ETFs and mutual funds adding exposure to these countries. There was a corresponding decrease in the P/E ratio in June 2014, which is when they officially moved over, confirming this viewpoint.

It is important to note there are not many Frontier Market managers, and most of the ones that are categorized as Frontier Markets are also allocated upwards of 30% to Emerging Markets. In addition, because of the liquidity constraints, many of these managers are already closed or are considering closing soon as they approach $1 billion in assets under management.

HIGHLAND'S VIEWPOINT

The Frontier Markets have many of the same attributes that aided Emerging Markets growth in the past. These include strong demographics, foreign direct investment, underpenetrated consumer market, cheap labor and abundant natural resources. In a low return environment, these attributes could lead to attractive equity markets. However, we have real concerns over the liquidity in these markets and the ability to access invested capital. Furthermore, the rule of law is not actively enforced and could be altered if there was a regime change. Terrorism is also present in these markets which adds an additional risk.

Focusing on risk is vitally important when constructing our clients' portfolio. Therefore, asset classes must have all of the following attributes, of which the Frontier Markets does not possess:

- Market Size
- Liquidity
- Transparency
- Diversification

Although the potential for higher growth and cheaper valuations makes the asset class desirable, it is our view that the current risk is higher than the potential reward. Therefore we would pass on investing in Frontier Markets. We will keep monitoring this asset class and look for catalysts that could warrant an allocation in the future.

HIGHLAND

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