



Frontier Market Indexes

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“Too much of a good thing can be wonderful” – Mae West

Beginning in 1996, the term “frontier market” was used by the International Finance Corporation to describe smaller markets that they tracked in an informal composite of 21 countries. The maintenance of this database was later taken over by S&P, and the composite was re-named the S&P/IFC Frontier Markets Composite. In July 2007, S&P introduced the S&P/IFC Extended Frontier 150, composed of the 150 largest and most liquid frontier companies, and they followed that with the S&P Select Frontier Index (a subset of the Frontier 150 that has 30 companies from 11 countries). In early 2009, S&P revised its frontier index with several changes including the addition of the Middle Eastern Gulf Cooperation Council countries (GCC). The new index is called the S&P Frontier BMI (Broad Market Index). Companies with a float-adjusted market capitalization greater than US\$ 100 million are eligible for the index. If the combined float-adjusted market capitalization of the stocks does not exceed 80% of a country’s total market capitalization, Standard & Poor’s will add companies that fall below the US\$ 100 million threshold until at least 80% of the market coverage is captured. Adjusted market capitalization of the index is \$252 billion and it includes 616 companies.

In December 2007, Morgan Stanley Capital International introduced the MSCI Frontier Markets Index, initially covering 19 countries and recently expanded to 25. Liquidity screens, company free-float adjusted market capitalization and minimum size references are used to create indices that are both investable and replicable. The index has a capitalization of \$113 billion and 185 constituents.

Both index providers also offer their frontier indexes in “ex-GCC” form, because some investors consider the rich Middle Eastern countries to be unique and different from the typically poor frontier countries.

We are delighted to see these indexes arrive because they focus more attention on this growing sector of the financial world. On the other hand, the variety of indexes can cause confusion. Also, because they are limited in the number of countries included, they could cause investors to neglect excellent frontier markets that are not part of the indexes.

Exhibit 1 shows the exposure of the main benchmarks to the five global regions. We have also included market capitalizations using the most recent (2007) data from the World Bank’s WDI database, <http://publications.worldbank.org/WDI/>. As shown, the regional weightings differ widely among the indexes.

Exhibit 1 – Index Comparison

	World Bank Mktcap	World Bank Mkt Cap %	S&P Frontier BMI	MSCI Frontier Market Index	World Bank Mktcap Ex-GCC	World Bank Mkt Cap Ex-GCC %	S&P Frontier BMI Ex-GCC	Frontier Market Index Ex-GCC
Africa	\$137,203	6.5%	12.4%	13.5%	\$137,203	13%	21%	36%
Asia	\$159,040	7.5%	12.4%	7.8%	\$159,040	15%	21%	21%
Europe	\$404,054	19.0%	7.1%	7.8%	\$404,054	38%	12%	21%
Latin Am	\$252,970	11.9%	20.1%	3.5%	\$252,970	24%	34%	9%
MidEast	\$1,172,161	55.1%	48.0%	67.5%	\$97,648	9%	12%	14%
	\$2,125,427	100.0%	100.0%	100.0%	\$1,050,914	100%	100%	100%
Countries	66	66	35	25	60	60	30	20

Source: World Bank, S&P, MSCI, 2009

The columns on the right show the weightings for each region in the indexes that exclude the GCC countries. Because of its low weighting in Latin America, the MSCI Frontier Index has higher weights in the other regions.

The five frontier regions, Africa, Eastern Europe, Asia, Latin America and the Middle East, all have unique opportunities and challenges, and they can provide excellent diversification benefits across regions. Africa may be awakening at last and joining the world of commerce thanks to demand for its commodities, improved politics and economics, and investment from abroad, especially from China. Eastern European frontier markets benefited from closer ties to Europe as well as the progress of their emerging country neighbors: Russia, Poland, Hungary and the Czech Republic. Recently, however, this has proven to be a mixed blessing, as many Eastern European countries indulged too heavily in the availability of credit from Western Europe prior to the 2008 crisis. On the other hand, many Asian frontier markets have copied some of the best practices of their neighbors China and India, while Latin American frontier markets such as Costa Rica, Colombia, Trinidad and Tobago and Jamaica have improving their economic policies and benefitted from their ties to the United States. Finally, countries in the Middle East are being recognized not just as sources of recycled petrodollars, but as investment destinations in their own right.

Turning to country level analysis, exhibit 2 summarizes those countries that are in either the MSCI Index or the S&P Index.

Exhibit 2 – Countries in the MSCI and/or S&P Frontier Markets Indexes

	Country	Population (million, 2007)	GDP per capita (2007)	Market Cap World Bank (2008, in \$Mil USD)	World Bank %	S&P Frontier BMI	MSCI Frontier Markets Index	S&P BMI Ex-GCC	MSCI Ex- GCC
Africa	Botswana	1.9	\$4,692	\$5,887	0.3%	0.5%	--	0.8%	--
Africa	Cote d'Ivoire	19.3	\$554	\$8,353	0.4%	0.5%	--	0.9%	--
Africa	Ghana	23.5	\$307	\$2,380	0.1%	0.1%	--	0.2%	--
Africa	Kenya	37.5	\$460	\$13,387	0.6%	1.3%	1.7%	2.3%	4.5%
Africa	Mauritius	1.3	\$4,709	\$5,666	0.3%	1.2%	0.8%	2.0%	2.1%
Africa	Namibia	2.1	\$2,258	\$702	0.0%	0.1%	--	0.2%	--
Africa	Nigeria	148.0	\$471	\$86,347	4.1%	7.9%	10.5%	13.4%	27.7%
Africa	Tunisia	10.2	\$2,652	\$5,355	0.3%	0.7%	0.5%	1.2%	1.3%
Asia	Bangladesh	158.6	\$439	\$6,793	0.3%	0.5%	--	0.9%	--
Asia	Kazakhstan	15.5	\$2,332	\$41,378	1.9%	5.9%	3.5%	10.0%	9.4%
Asia	Pakistan	162.4	\$654	\$70,262	3.3%	2.8%	2.2%	4.8%	5.8%
Asia	Sri Lanka	19.9	\$1,140	\$7,553	0.4%	1.1%	0.5%	1.8%	1.3%
Asia	Vietnam	85.1	\$617	\$19,542	0.9%	2.1%	1.6%	3.5%	4.1%
Europe	Bulgaria	7.6	\$2,401	\$21,793	1.0%	0.2%	0.1%	0.4%	0.4%
Europe	Croatia	4.4	\$5,794	\$65,977	3.1%	1.6%	2.4%	2.8%	6.2%
Europe	Estonia	1.3	\$7,180	\$6,037	0.3%	0.3%	0.3%	0.5%	0.9%
Europe	Latvia	2.3	\$6,315	\$3,111	0.1%	0.04%	--	0.1%	--
Europe	Lithuania	3.4	\$5,772	\$10,134	0.5%	0.3%	0.1%	0.6%	0.4%
Europe	Romania	21.5	\$2,596	\$44,925	2.1%	1.1%	0.8%	1.8%	2.2%
Europe	Serbia and Montenegro	7.4	\$1,780	\$23,934	1.1%	--	0.2%	--	0.5%
Europe	Slovak Republic	5.4	\$5,733	\$6,971	0.3%	0.1%	--	0.1%	--
Europe	Slovenia	2.0	\$13,334	\$28,963	1.4%	2.7%	3.3%	4.6%	8.9%
Europe	Ukraine	46.4	\$1,123	\$111,757	5.3%	0.7%	0.4%	1.2%	1.2%
Latin Am	Argentina	39.5	\$9,357	\$86,684	4.1%	3.1%	2.4%	5.2%	6.3%
Latin Am	Colombia	46.1	\$2,980	\$101,956	4.8%	14.5%	-	24.6%	-
Latin Am	Ecuador	13.3	\$1,660	\$4,266	0.2%	0.4%	-	0.7%	-
Latin Am	Jamaica	2.7	\$3,091	\$12,335	0.6%	0.3%	-	0.6%	-
Latin Am	Panama	3.3	\$5,200	\$6,219	0.3%	1.1%	-	1.9%	-
Latin Am	Trinidad and Tobago	1.3	\$10,657	\$15,605	0.7%	0.7%	1.1%	1.1%	2.9%
MidEast	Bahrain	0.8	\$14,776	\$28,134	1.3%	2.0%	1.7%	--	--
MidEast	Jordan	5.7	\$2,248	\$41,216	1.9%	4.2%	3.0%	7.2%	7.9%
MidEast	Kuwait	2.7	\$23,142	\$188,046	8.8%	20.8%	34.8%	--	--
MidEast	Lebanon	4.1	\$5,111	\$10,858	0.5%	2.8%	2.3%	4.8%	6.2%
MidEast	Oman	2.6	\$10,506	\$23,060	1.1%	2.3%	3.3%	--	--
MidEast	Qatar	0.8	\$32,755	\$95,488	4.5%	7.4%	9.5%	--	--
MidEast	United Arab Emirates	4.4	\$25,192	\$224,675	10.6%	8.6%	12.9%	--	--
	Total	914.4	\$6,111	\$1,435,749	67.6%	100.0%	100.0%	100.0%	100.0%

Source: World Bank, S&P, MSCI, 2009

Of thirty six countries in one of the frontier indexes, Serbia is unique to MSCI while Botswana, Cote d'Ivoire, Ghana, Namibia, Bangladesh, Latvia, Slovakia, Colombia, Ecuador, Jamaica and Panama are unique to S&P.

It is interesting that five of the markets in these indexes have GDP/capita over \$11,906 and thus are "high income" countries in the eyes of the World Bank: Arab Emirates - \$25,192, Kuwait - \$23,142, Qatar - \$32,755, Bahrain - \$14,776 and Slovenia - \$13,334. We could consider them as "frontier" only in the sense that they are outside the normal investment universe of developed and emerging markets, but they are certainly different from countries like Kenya - \$460 or Vietnam - \$617.

Furthermore, it is hard to imagine wanting to use a normal portfolio weight in Kuwait of 34.9% as it is in the MSCI Frontier Index or even the 20.8% weight of the S&P Frontier BMI. Thus some investors may prefer the benchmarks excluding the countries in the Gulf Cooperation Council (ex-GCC), which account for 41% of the S&P Frontier BMI Index and 62% of the MSCI Frontier Index. These ex-GCC indexes are shown in the right hand columns of exhibits 2 and 3.

Unfortunately, they have issues of their own. In the S&P Index, Colombia swells to a 24.6% weight, whereas it does not appear at all in the MSCI Index (because MSCI has considered Colombia to be an emerging market since 1993). Thus an investor who uses the MSCI Emerging Market Index but prefers the broader frontier country list of S&P would need to consider possible duplication of portfolio weights in Colombia.

Another issue concerns Nigeria, which is 13.4% of the S&P Frontier BMI ex-GCC and 27.7% of the MSCI Frontier ex-GCC. Nigeria has been described by one local broker as "a big oil company with a small economy attached". The country has been challenged by bombings, kidnappings and corruption. Local banks dominate the market, and recently problem loans have forced the government to seize five banks and detain numerous executives. Although Nigeria is definitely a frontier country, it is difficult to justify investing a quarter of one's frontier portfolio there.

Exhibit 3 summarizes an additional 26 frontier countries that are ignored by the current frontier market indexes. These countries represent over 330 million people and account for over 30% of the World Bank frontier market capitalization. Of the three largest, Saudi Arabia remains closed to all foreign investors, while Iran is forbidden for U.S. investors. Next is Cyprus, where the stock market has many stocks that are cross-listed in Greece. Among the others, Zimbabwe is a troubled state where inflation reportedly reached 231,000,000% in July 2008. The stock market there has been a hedge against inflation for locals, but it has been hard to get money in or out until the recent de facto dollarization of the economy in 2009. Venezuela is fourth in size on the list, but the political problems and nationalizations there may keep investors away for some time.

The remaining 21 countries include many that represent precisely what frontier market investing is all about. They include many countries that have stock markets with the potential to grow based on improved economic policies. Sometimes their political environments lean towards autocratic, as in Uzbekistan and Uganda, but this is little different from conditions in frontier Kazakhstan or emerging markets like Egypt, Russia or China. Many of these small frontier countries are hard to get to. When traveling in Africa, it seems that most flights require a change of planes in either Johannesburg or Nairobi. And investing in many of these countries is can be tedious, with multiple registration forms and lengthy delays. For example, in order to have documents registered in Uzbekistan, they must be notarized first in the U.S. county, state and State Department. On the other hand, we have found that investing in several of these countries, such as Malawi, Tanzania, Zambia, Mongolia and Costa Rica can be relatively easy.

Exhibit 3

		Population (2007)	GDP per capita 2007	Market Cap World Bank (2007) \$Mil USD	World Bank %
Africa	Malawi	13.9	\$153	\$587	0.03%
Africa	Swaziland	1.1	\$1,547	\$203	0.01%
Africa	Tanzania	40.4	\$354	\$541	0.03%
Africa	Uganda	30.9	\$324	\$116	0.01%
Africa	Zambia	11.9	\$386	\$2,346	0.11%
Africa	Zimbabwe	13.4	NA	\$5,333	0.25%
Asia	Fiji	0.8	\$2,202	\$522	0.02%
Asia	Georgia	4.4	\$1,218	\$1,389	0.07%
Asia	Kyrgyz Republic	5.2	\$352	\$121	0.01%
Asia	Mongolia	2.6	\$684	\$612	0.03%
Asia	Nepal	28.1	\$246	\$4,909	0.23%
Asia	Uzbekistan	26.9	\$783	\$715	0.03%
Europe	Armenia	3.0	\$1,457	\$105	0.00%
Europe	Cyprus	0.8	\$13,872	\$29,479	1.39%
Europe	Macedonia, FYR	2.0	\$2,061	\$2,715	0.13%
Europe	Malta	0.4	\$10,627	\$5,633	0.27%
Latin Am	Barbados	0.3	\$8,454	\$5,599	0.26%
Latin Am	Bolivia	9.5	\$1,126	\$2,263	0.11%
Latin Am	Cayman Islands	0.05	\$43,800	\$183	0.01%
Latin Am	Costa Rica	4.5	\$5,120	\$2,035	0.10%
Latin Am	El Salvador	6.9	\$2,336	\$6,743	0.32%
Latin Am	Guyana	0.7	\$1,062	\$262	0.01%
Latin Am	Uruguay	3.3	\$7,485	\$159	0.01%
Latin Am	Venezuela, RB	27.5	\$5,784	\$8,251	0.39%
MidEast	Iran, Islamic Rep.	71.0	\$2,137	\$45,574	2.14%
MidEast	Saudi Arabia	24.2	\$10,020	\$515,111	24.24%
	Total	334.0	\$4,944	\$641,508	30.18%

Source: World Bank, S&P, MSCI, 2009

We believe that all of the frontier indexes are useful for comparisons with active investment results in the frontier markets. However, active investors in the frontier are likely to deviate significantly from the float weighted exposures of indexes, especially in the current environment that is characterized by many market inefficiencies. Thus, clients should allow a broad tracking error band of 10% or more for most active frontier portfolios relative to the indexes

About Frontier Market Asset Management

Founded in 2006, Frontier Market Asset Management holds more than 35 years worth of investment experience including work in Emerging and Frontier Markets since 1987. For more information, please contact us at (858) 456-1440.

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