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Rediscovering Frontier Ethic of Investing

By ANNELENA LOBB

As risk appetite swells around the world, investors are moving money beyond the developed and emerging world to the smallest, most-volatile markets.

Countries from Croatia to Nigeria and Sri Lanka are back on radar screens after stocks there took a beating late last year and into this one.

Frontier markets are generally those that don't make it to "emerging" status because they are too small, illiquid or otherwise inaccessible. Those very traits can make their price swings more drastic and the risks far higher.

With markets lately rising, even the riskiest investments are finding takers. The run-up in commodities also has piqued investors' interest in the smaller countries that often supply them.

Frontier markets were overvalued a year back, says Conrad Saldanha, who runs Neuberger Berman Emerging Markets Equity Strategy, with about \$150 million of assets and a mandate that includes the frontier markets. "At the peak of the cycle, investors go for the riskiest assets. Now some look cheap," he says.

Frontier markets enjoyed a run of fame in 2007 and into 2008, when they surged amid the global rally's last hurrah. As many frontier markets logged double- or even triple-digit percentage increases in 2007, a series of funds and related products were launched. They were heavily marketed as largely uncorrelated with other markets, meaning they didn't move in lockstep with other markets, making them a good way to diversify a portfolio.

The financial crisis last fall crushed stock markets world-wide, including those on the frontier. Some of those new funds debuted just in time for the massive bust.

Lately, the belief that frontier markets will again decouple from developed ones is gaining traction says Ayo Salami, chief investment officer for Africa at the Duet Group in London and manager of its African Opportunities Fund. He is now buying consumer-goods stocks in Nigeria, Kenya, Ivory Coast and Botswana. "The economies will drive the markets in different directions," he says. "Investors are starting to wake up to that."

MSCI's frontier-markets index, containing stocks from 25 countries, peaked in January 2008, then plunged 69% by early March 2009. Since then, the index has jumped 51%. The Standard & Poor's 500 stock index's peak-to-trough decline was slightly less drastic -- a 57% drop from its October 2007 high -- and its subsequent rise from its March low has been smaller, at 39%.

Frontaura Capital LLC runs a frontier-markets equity fund that launched in November 2007. The Chicago firm estimates the fund is up 26% for 2009, taking its performance back roughly to the levels of early October 2008.

"Some months you cannot wait for the calendar page to turn, while others you wish would never end. May was an example of the latter," wrote managing director Nick Padgett in a monthly note to investors.

Mr. Saldanha at Neuberger says that about a year ago Nigerian banks traded at about eight times their book value but now trade at book value. "There's been a massive de-rating. That factors in the risk with it being a frontier market...and gives you a pretty good upside," he says.

Mr. Saldanha says about 2.5% of his portfolio is now in frontier markets, up from zero about six months ago. Some of the exposure is through listings such as American depositary receipts, securities that represent shares of a foreign company but are traded on a U.S. exchange, and global depositary receipts, securities of foreign companies that trade on exchanges outside their local exchange. "We've kept enough latitude to invest further in [frontier markets] if need be," he says.

Lawrence Speidell, founding partner and chief investment officer of Frontier Markets Asset Management, sees good investments in such countries as Ivory Coast, Zambia, Romania and Slovenia. He says Zambia, for one, is copper-rich, and rising copper prices could help spur a rally there. Zambian stocks haven't kept pace with stocks in other copper-producing countries, he says.

While commodities are a driver in many frontier markets, so are long-term domestic growth prospects. "The long-term story is convergence of incomes, technology, and living standards, labor costs and so on," Mr. Speidell says. "You should see rising personal disposable income, so you invest in consumer products, banking services."

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