FRONTIER MARKET
Asset Management, LLC
...the road less traveled

Between the Seas – Jamaica, Panama, Costa Rica, and Papua New Guinea

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"Faithful to my past, when they try to stop me, I go on." – Ferdinand De Lesseps

Central American and Caribbean countries share proximity in location but appear distant in their prospects for the future. Recently, we visited Jamaica, Panama and Costa Rica.

Source: CIA World Fact Book; www.cia.gov

Jamaica, endowed with natural beauty, is held back by crime and an unfriendly business environment. Panama is reminiscent of Singapore and Dubai in its pro-market orientation and its skyline. Of the three Central American countries, Costa Rica is most successful in attracting foreign direct investment. The government is stable and business friendly, and the labor force is educated and skilled. Across the Pacific from Costa Rica, in Papua New Guinea, we found another government benefitting from a recent influx of foreign investment. Although this is primarily due to the recent discovery of oil and natural gas, rather than the sort of sound policymaking seen in Costa Rica, Papua New Guinea's economy is booming nevertheless.

JAMAICA

Jamaican children playing on a field trip

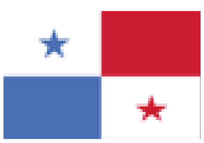
Jamaica was discovered by Christopher Columbus in 1494 and was a home to Spanish settlers for over a century. Britain took control in the mid seventeenth century. The indigenous population was gradually replaced by African slaves. It was not until 1962 that Jamaica gained its independence. Over the years, the economy changed from agricultural, with focus on sugar, cocoa, and tobacco, to service oriented. Today, services account for 65% of output. Tourism (primarily of US and Canadian citizens), remittances, and bauxite production are of highest significance. Ironically, as a Scotia Bank manager pointed out, the sugar industry is now uncompetitive. The locals talk of pending Chinese investment to revive the sector.

As I travelled to Jamaica, I thought of potential drivers for the island's growth. The location is of importance, being just south of Cuba and on the way to the Panama Canal. This could be promising with the possible economic opening of Cuba in the future and the current expansion of the Panama Canal. The population is young, literate, and English speaking. Productivity gains are possible with half of the population still living in rural areas.

As we visit with company management and locals, however, we learned of significant challenges. High levels of unemployment and violent crime are most serious. The first appears to be a structural problem, with lack of sector diversification and dependence on imports. The tax code also seems archaic when compared to neighboring Panama and Costa Rica. The personal tax rate is 25% while corporate is at 33.3%. The government is contemplating some changes to the tax structure. The establishment of a junior market (OTC-like) 10% tax holiday seems to be a step in the right direction. However, options are limited. The government overspent protecting inefficient enterprises in the 1990s and now faces more than 120% Debt to GDP burden, the fourth highest per capita in the world. The crime level is also alarming, with a murder rate about tenfold that in the US. The capture of a gang leader last year, however, has led to a 40% drop in fatalities. This is very encouraging and, if sustained, can have positive impact on business costs and foreign investment in the country.

During our visit we met with companies and brokerage firms. We were generally impressed with the intellectual talent, although a bit discouraged by the lack of urgency. In the context of fourteen consecutive quarters with GDP decline, I guess that attitude may be understandable. Our trip was motivated by the cheap valuations of the stocks in Jamaica. Our search for growth, however, failed to produce strong candidates for the portfolio. The banking sector is looking to resume lending, but with limited prospects for the economy, growth will probably be restrained. Other corporations are suffering from limited consumer demand and high input costs. Next we traveled south to the Isthmus. And what a difference!

Downtown Kingstown



PANAMA[1]

Panama was discovered by the Spanish in the 16th century and gained its first independence from Spain in 1821. For the better part of the century, however, Panama remained a part of Colombia, and it finally gained its second independence in 1903. Between 1904 and 1914, after a failed attempt by the French, the US Army Corps of Engineers built the Panama Canal. The transfer of canal operations from the US to Panama was completed in 1999. The Canal is currently undergoing a major upgrade and expansion, which intends to double capacity by 2014.

In a recent article on the country, *The Economist* (July 14, 2011) quoted Panama's President Ricardo Martinelli suggesting "We copy a lot from Singapore and we need to copy more". The article titled "*Panama's Economy: A Singapore for Central America?"* rightfully pointed to the business friendly environment of the country. Foreign firms with regional headquarters in Panama (such as Procter & Gamble and Caterpillar) benefit from corporate and income tax holidays. Trade is encouraged with low import tariffs. Labor costs are competitive at approximately $400 per month per person for blue collar work. The expansion of the canal, combined with an ambitious public infrastructure plan, is providing additional stimulus. Real GDP grew more than 7% in 2010 and is expected to grow by 6% on average over the next five years, according to the IMF.

Panama City: greener than Dubai, as humid as Singapore and aspiring to emulate the Asian success story

The Economist also highlighted some concerns. The rule of law is one. A few of the local business people we met shared a concern over the competing interests of President Martinelli. In addition to running the country, Mr. Martinelli is also the owner of one of the two largest supermarket chains in the country. Corruption is a hindrance, especially in light of large public spending. Money laundering and drug trafficking are problems dating back decades if not centuries. Income inequality is still substantial. However, with low indebtedness, pro-market environment, and significant infrastructure expansion, the country has enough firepower to sustain strong growth and spread the wealth through the population.

Melo Headquarters embedded next to its Home Center store

Our company meetings showed evidence of early success. The largest bank, Banco General, shared with us that consumer loans as well as low and mid-market mortgage loans are growing steadily. Grupo Melo, which operates the largest low-end fast food chain, forecasted sales growth in the double digits. Other Grupo Melo divisions showing growth are home centers and pet stores, which target the rising middle class. Encouraged by our visit, we made our first investment in Panama, in Grupo Melo. In addition to having good growth prospects, the company trades at an attractive valuation. Unfortunately, there were no other stocks that met our criteria, but we will keep a close eye on the Panama stock market, and continue to monitor its progress.

COSTA RICA

Costa Rica gained its independence from Spain in 1821 and sovereignty in 1838. Interestingly, in 1949, the country dissolved its army. Costa Rica has a democratic and stable government, which has attracted foreign direct investment and migration from abroad. The agriculturally based economy has been transformed into one with service orientation. The main industries are tourism and technology, with the latter benefiting from the establishment of free trade zones. Foreign direct investment per capita is the highest in Latin America and prospects remain strong.

Intel chose Costa Rica for its manufacturing operations

The population is educated and often bilingual. The cost of labor, although higher than that of Panama, is still reasonable. The country's location is strategic and convenient for multinationals. The benevolent tax code for trade is yet another attraction for investors. In 2004, Intel chose Costa Rica over Mexico and Peru for its new Latin American manufacturing facility. Their investment was so significant that during its first year of operation, the Intel facilities added between 1% and 2% to the real GDP growth of the country. Most recently, in March of 2011, Costa Rica signed a free trade agreement with China. While the long-term impact of the treaty is undefined, the immediate benefit is a $$65 million commitment from the Chinese for the building of a new stadium for its widely popular national football team.

The stock market in Costa Rica is one of the smallest in the frontier. In fact, our sole holding there is the only publicly traded company, Florida Ice and Farm Company, known as FIFCO. The company controls 99% of the combined local and import beer market, thanks to its lock on the licensed liquor distribution. Heineken, which gave FIFCO its very first license to manufacture outside of Holland, is a 25% owner in the beer business. The company also bottles for Pepsi, which is ramping up its market share against Coca-Cola. Other areas of growth include the newer natural water and juice divisions. Lastly, FIFCO owns two tourist resorts on the coast and prime land in the capital of San Jose. While management was guarded about disclosing estimates of the real estate worth, they said that most of the land was acquired twenty years ago. In all, our positive view of the visit with the company reaffirmed our liking for the stock.

At FIFCO and ready for a meeting with Orlando Sota Solera of Acobo.

	Jamaica:	Panama:	Costa Rica:	Papua New Guinea:
GDP/Cap (PPP), 2010	$8,300	$13,000	$11,400	$2,400
GDP Growth, 2010	-1.1%	7.5%	4.2%	19.8%
Inflation	12.6%	3.3%	5.7%	7.8%
Population (Millions)	2.868	3.460	4.576	6.890
% Under Age 15	31.1%	28.6%	24.6%	39.8%
People Per Km Sq.	261	46	90	15
Literacy Rate	87.9%	91.9%	94.9%	60.1%
Life Expectancy (years)	73	78	78	61
Unemployment Rate	12.9%	4.2%	7.3%	1.8%

Source: CIA World Fact Book; World Bank; Frontier Market Asset Management estimates.

PAPUA NEW GUINEA

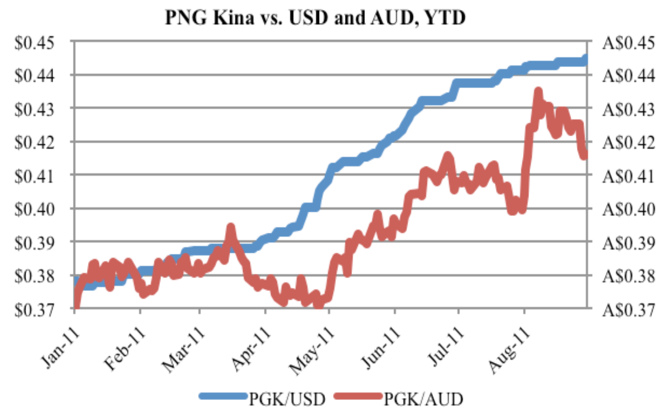
Jonathan "JB" Dill joined Frontier Market Asset Management in September 2011. A recent graduate of Bowdoin College in Brunswick, Maine, JB joins the investment team as Research Associate, working in our Camas, Washington office with Thea. In August, JB spent two weeks in Papua New Guinea, and we asked him to share his experience with us.

Much has changed in Papua New Guinea (PNG) over the past ten years. When I first visited the country in 2001, it remained much as it was at the dusk of colonial times. Having just celebrated twenty-five years of independence from Australia, PNG's economy remained stagnant and national politics amounted to little more than a distributive struggle between the country's numerous ethnic groups. Measured at purchasing power parity, gross domestic product per capita was slightly less in 2001 ($1,895) than in 1980 ($1937). Decades of economic hardship bred widespread unrest. The government had recently imported South African mercenaries to repress a secessionist movement on Bougainville Island, and I had arrived in the central highlands to discover the lone hotel had closed due to an outbreak in tribal warfare. On the bright side, this setback led to a memorable encounter with the Asaro 'Mud Men', who settle their tribal disputes through sorcery (see photo below).

Source: CIA World Fact Book: www.cia.gov

Today, however, PNG finds itself at both an economic and political crossroads. In many ways, the country's economic prospects seem bright. An influx of foreign investment has revived PNG's mining sector. There are now nine active gold mines in the country and five additional mines are under development. Moreover, recent discoveries of oil and natural gas have attracted the likes of ExxonMobil, which is nearing completion on the first train of its 'PNG LNG' project and is already hinting at a forthcoming investment in a second train. ExxonMobil's success has prompted the arrival of at least ten additional companies currently prospecting for oil and gas reserves in PNG's highlands. Locals believe it is only a matter of time until more discoveries are made and PNG becomes a major player in the global oil industry. A local even claimed that the northern Madang Province is home to enormous and undeveloped natural gas reserves that seep through the ground, causing several people's cigarettes to explode upon being lit. Another notable believer in PNG's burgeoning

An Asaro 'Mud Man' in PNG's central Highlands oil and gas sectors is George Soros, whose Quantum Fund recently invested $20 million in the ASX-listed New Guinea Energy.



Source: The Bank of New Guinea, http://www.bankpng.gov.pg/

Although PNG is now on the verge of a fully-fledged natural resource boom, future prosperity is not guaranteed. The government recently created Petromin PNG, a state-owned company designed to siphon oil and mining revenues into government coffers. Given PNG's history of corruption (even Iran and Zimbabwe fare better on the Corruption Perceptions Index), it is very plausible that Petromin's revenues will be squandered as patronage, rather than productively invested. Even if Petromin manages to stay beyond the reach of corrupt politicians, the rapidly appreciating Kina, the currency of PNG, is another source of economic uncertainty. The Kina's appreciation has made imports relatively less expensive for domestic consumers and made PNG's exports relatively more expensive for foreign trading partners. If this trend continues, it may undermine both domestic and foreign demand for goods produced in PNG's non-resource sectors. Thus, while PNG's GDP per capita (PPP) has risen 31 percent since 2005, the country's economic prospects remain uncertain.

The political situation also remains somewhat murky. Sir Michael Somare, who led PNG's independence movement and became the country's first Prime Minister in 1975, was voted back into office in 2002. His return seemed to have a unifying effect on the country. Although tribal tensions still simmered and 'rascals' continued their roadside banditry on the outskirts of Port Moresby, larger problems, such as the secessionist movement on Bougainville Island, were resolved. In May of this year, however, Sir Michael fell ill and hopped an emergency flight to Singapore for heart surgery. He left the country in the hands of Sam Abal, a trusted loyalist. Shortly thereafter, Mr. Abal found himself in the middle a national controversy after his stepson allegedly murdered a woman and dumped the body in the gardens surrounding the Prime Minister's mansion. Meanwhile, Sir Michael's health continued to deteriorate, and, in early August, the man known as PNG's "Great Chief" permanently retired from politics. Since assuming the post of Prime Minister on a full time basis, Mr. Abal has promised to rid the government of "materialism and power-hunger." Whether or not he either cares to or can succeed is an open question. The oil and mining boom should provide the government with the means of jumpstarting the economy, but corruption will inevitably stand in the path of progress. Fortunately, PNG's judiciary has remained remarkably independent despite the corruption found in other branches of government. As an example, a recent Supreme Court investigation into corruption forced the government to auction

The Huli 'Wig Men', who live in PNG's Highlands, were one of the last discovered people's on Earth.

off the presidential jet. If both the courts and the citizenry continue enforcing accountability upon the ruling elite, little else should stand in the way of PNG's continued economic development and political stability.

With this cautious optimism for PNG's economic and political prospects, I visited the folks at Bank South Pacific, which owns and operates the Port Moresby Stock Exchange (Pomsox). Although oil and mining companies dominate the Pomsox, our discussion focused on those businesses that are tapping into PNG's resource-driven development from a variety of angles. One example is Credit Corporation, which makes short-term loans to oil and mining companies looking to purchase supplies in the local marketplace. Another company, City Pharmacies Limited, is profiting from the emerging middle class that continues to grow around the influx of foreign investment. Built around its flagship chain of pharmacies, City Pharmacies is a conglomerate with interests in a number of businesses, including 'Stop-n-Shop' supermarkets and a soon to be built cinema in Port Moresby. Bank South Pacific is also benefitting from PNG's growing middle class, which increasingly demands access to debit cards, ATM services, and mobile banking networks. Although these companies appear well positioned to capitalize on PNG's growth, several looming questions remain. In the short term, the question is whether or not the middle class can survive inflationary pressures, which have already caused food prices to triple over the past three years. Perhaps the more daunting question relates to PNG's long-term prospects. Is the country's economic development sustainable or will the budding middle class simply disappear when foreign investment dries up in the wake of depleted oil and mineral reserves?

CONCLUSION

Our trip to Central America confirmed our concern for the growth outlook of the Caribbean islands. We were, however, enlightened by the visit in Panama, a country with a strong economy and good long-term prospects. In Costa Rica, our meeting with FIFCO was invaluable as it added faces and conviction to a company we had followed for a while. We also took away an appreciation for the country's efforts to diversify its economy from a tourist hub only, with the right mix of investment incentives. To that end, we hope to see similar reforms in Papua New Guinea, where a volatile business environment still shrouds the country's future in uncertainty.

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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[1] Our partners who relish history may enjoy reading "*The Path Between The Seas*" by David McCullough. On page 112, the author succinctly depicts early Panama: "A Cueva Indian word, Panama means "a place where many fishes are taken." For the Spanish, Panama became a marshaling point and clearinghouse for the most important crossroad in the New World, the *camino real*, or royal road, which was nothing more than a narrow mean mule track cut from Panama to Nombre de Dios, then the one Spanish fort on the Caribbean side. The gold of the Incas, pearls, Bolivian silver – no one knows how many thousands of tons of treasure – went across to Nombre de Dios, to be picked up by Spanish galleons. And though Panama never became especially large – because of disease primarily – or achieved the fabled wealth pictured in some old accounts, its importance was considerable. The stone ruins of the original city, Old Panama, or Panama Viejo, still stood several miles down the bay. The site had been abandoned after the city was sacked and burned by the pirate Morgan in 1671, and the present Panama, a walled city, was begun three years later, at the head of the bay, on a narrow tongue of volcanic rock with water on three sides…"