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Frontier Markets in the Spotlight: Rapid Growth Propelled by Reform

Hubbis and exclusive partner for the event Fiera Capital Corporation (Fiera) assembled an erudite group of 15 gatekeepers, asset managers and CIOs for a private and off-the-record discussion on the development of frontier and MENA markets

The key takeaways

Reform the essential catalyst

Reform is the driver for performance in frontier market investing. There is a one-to-one correlation between reform and economic growth. Just look at Asia in the past 30 years, where political, economic and financial market reforms have led to dramatic growth in GDP and in company earnings.

But reforms can be derailed

Although the outlook for reform in frontier Middle East markets and in countries such as Vietnam currently are encouraging, a watchful eye must be maintained, in case the next Argentina, Venezuela or Turkey is around the corner. Only 15 years ago, Venezuela was the wealthiest country in Latin America, but today it is an economic and political disaster zone.

Vietnam shines

Vietnam is perhaps the single most glaring frontier market opportunity, with what experts believe is a very sustainable political reform process, a sustainable economic reform process and genuine growth in the economy and in corporate performance.

Eastern Europe also performs

Of the 27 countries of Eastern Europe that were formerly USSR states before the Berlin Wall fell in 1989, Romania and Poland are producing the fastest growth in the whole of Europe.

The Middle East's appeals

Reforms are taking place across Saudi Arabia and the UAE countries, with some of the nearby countries such as Egypt also notable for their reforms.

Frontier markets = low foreign investment

As well as rapid growth propelled by reforms, frontier markets are characterised by minimal focus from outside investors, as well as minimal research coverage. This opens the door for outperformance by funds driven by bottom-up fundamental research and financial modelling to identify major alpha-generating opportunities.

Growing the averages

The average frontier market is roughly 5% owned by foreign investors, while the average well-developed emerging market is nearer 50% owned by foreign investors.

No need to benchmark

Active funds such as Fiera's Magna New Frontiers Fund do not need to benchmark against the MSCI Frontier Markets index, which might not be that representative of the universe of opportunity, with the biggest stocks, often private firms, highly, or often excessively valued. Alpha generators are not always found in the financial sector, which dominate some 50% of the index, for example, or in the larger privatised ex-state entities segment.

Domestic growth a key driver

Fiera focuses mostly on domestic stocks benefitting from domestic consumption growth, for example retail, white goods, brown good, education, or healthcare. These stocks should benefit from the type of expansion seen in the emerging markets of Asia in the past 20 to 30 years.

Liquidity is available

The average market capitalisation of the stocks currently in the portfolio is around UDS 5bn. Some of the companies in the Saudi market, for example, are valued at more than USD30 billion and the overall market trades about USD1 billion a day. Vietnam trades around USD250 million a day.

Currencies not a major issue

Fiera's managers do not hedge their currency exposures. Partly this is because currencies in some key markets such as the Middle East are dollar pegged, and partly because currency issues will show up in fiscal or political changes before any crisis emerges, at least for those experts' closely watching developments.

Good governance

Fiera highlighted the vital importance of corporate governance from all aspects, including respect for minority shareholder rights, appropriate dividend distributions, fairness in related party transactions, fair valuation for transactions, sensible allocation of capital, and so forth.

Low correlation

Frontier markets as an asset class have a very low correlation to emerging or developed markets. For example, the Pakistan index over the last year is down about 60% in US dollars but that has zero impact on Saudi Arabia where there is a very positive reform process, an MSCI upgrade cycle, hence the market in the last year is up about 20% in US dollars.

The Iran contagion

Fiera considers the Iran problem no different from the situation of the past several decades, no better and no worse. Fiera considers that what is going on in the ground in the Middle East is massively different from what is perceived by looking at the newspapers, and there is no escalation of the problems currently, and Fiera also considers the current period of economic stability in the region better than any period in the past half century.

Avoiding Africa

Fiera's team have great concerns about Africa as frontier markets, largely because of internecine strife between races and tribes that have somewhat arbitrarily been carved into countries by colonialists passing back control of the region decades ago. Since independence started in the late 50s, no country has grown sustainably for any real period of time, Fiera reported.

But what about China in Africa?

Don't be fooled by China's wholesale investments in Africa. Their mission is to gain access to cheap resources and commodities and the price for doing so is quid pro quo investment in infrastructure.

Keeping an eye out

Kazakhstan and Uzbekistan might be frontier markets in which to invest in coming years if reforms do indeed gain traction. One key way of playing those markets is indirectly, for example Fiera invests in a bank in Georgia that itself invests in the banking sector in Uzbekistan.

FRONTIER MARKETS ARE NOT ONLY fascinating, but if approached properly they can be the source of impressive alpha generation. Fiera's lead portfolio manager for the firm's flagship Magna New Frontiers Fund, Dominic Bokor-Ingram, took the floor.

"What we look for first in frontier market investing is reform processes," he began, "because in our experience of 30 years in emerging markets economic growth is generated with a one-to-one correlation when you get reform processes. Reforms whether they are political, economic or stock market reforms create economic growth. And the best place to look for companies that can compound their earnings over many years is in countries that are reforming."

Reform = opportunity

Bokor-Ingram points to Asia, where he observed that in the past 30 plus years huge reforms have taken place which have led to multi-year economic growth opportunities. "Emerging markets as we know," he reported, "are about growth, so finding the right companies that can participate in that growth is the key and that is our remit from start of the investment process to the end."

But he noted that it is not always a one-way street to performance, and his and his colleagues' roles are therefore to assess sustainability of reforms. As an example of reform processes going in the opposite direction, he cited Venezuela.

Watch out for the U-turns

"New democracies and new reforms are not always sustainable and rely on the will of the politicians and the motivation of the people to sustain them. Venezuela some 15 years ago was the wealthiest country in Latin America, had a constitution that looks very much like the US Constitution, but today is one of the biggest economic disasters in global history. And this in a country that has the largest oil reserves of any country in the world."

The frontier market beacons

Looking around the globe, he focused on Vietnam as the standout opportunity. "We see a very sustainable political reform process, a sustainable economic reform process which is producing genuine growth in the economy and genuine growth in companies."

Turning to the 27 countries of Eastern Europe, he noted that Romania and Poland are produc-

ing the fastest growth in the whole of Europe.

And he explained that the fund is heavily invested in a number of Middle Eastern countries where after many decades of not reforming, change is taking place. "Saudi Arabia is probably the standout country right now where real reforms are actually happening, but we still need to see if those reforms continue with a higher oil price. Kuwait, Dubai, and some of the other countries in the region such as Egypt and Morocco are also notable for their reforms."

But as with Venezuela there are the countries that exhibit the opposite characteristics. "Nigeria has huge oil reserves but an economic and political system that is far from conducive to private enterprise or economic growth."

Foreign investors will follow, but slowly

He noted that as well as rapid growth and reform, frontier markets are characterised by minimal focus from outside investors, as well as few analysts covering the stocks, allowing Fiera's bottom-up fundamental research and financial modelling to identify major alpha-generating opportunities and very big differences in valuation between what the market is thinking and what we might Fiera might believe.

"Your average frontier market is 5% owned by foreign investors," he noted, "while the average well-developed emerging market is more like 50% owned by foreign investors."

He remarked that one of the biggest problems in these youthful markets is misallocation of capital. Financial and markets reforms oil the wheels, followed by rising foreign ownership and the resultant re-rating should then take place. "We have seen a number of examples in recent history of markets going through exactly this process and then being upgraded to MSCI Emerging Market status and doing fantastically well."

But he also noted that this does not always happen, due to the possible reversal of the political or economic reforms. "We identify some 165 countries in the world that are not developed and not emerging and that have the potential to go through this reform and upgrade cycle, but at any point in time we focus on a universe narrowed down to about seven or eight situations."

Steering away from benchmarks

A guest asked why the MSCI Frontier Market index had not outperformed the equivalent emerging market index in the past three to five years.

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Fiera Capital

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"First, I would say that the MSCI is not that representative of the opportunity set," he explained. "MSCI is an organisation that puts together indices based on what their clients are focussing on and what mainly their ETF clients can invest in. But if you look at our frontier fund over the last five years, on average, we have been 80% non-benchmark holdings relative to the MSCI Frontier Markets benchmark. And as a result, relative to any emerging market fund we have actually outperformed over that period. Note that it is also a quirk of MSCI, which at some point they will have to sort out, it has become so China dominated that your average active investor is underweight China because they can only invest 20% in any one country and China is 30% of the index."

Financials play a key role

Another guest noted that the MSCI Frontier Market is still dominated as to roughly 50% by financials. "In frontier markets the banks tend to be very simple in what they do and very simple to analyse," Bokor-Ingram commented. "Most of them take deposits from consumers and corporates and invest in government T-bills. And that is the

RICHARD NINO
Fiera Capital

method by which the governments have been used to financing their budget deficits. When an economy opens up, the growth has to come from either the government spending more money, or foreign direct investment, or the banks starting to lend, but generally the governments do not have the money at that stage and foreign money has yet to follow through, as they want to see a period of stability first."

Accordingly, he explained that the banks are the drivers and they are not involved in complex transactions, they are simply lending domestically, and their margin is the difference between the deposit costs and their lending margins. "Moreover," he added, "within that financials bucket, if you look at the MSCI classification you also have insurance and usually real estate, which both tend to be leading indicators of economic activity as well. So, I would say financials are probably here to stay as a big percentage of any frontier markets benchmark."

Size and liquidity

He was asked about the average size of the companies in which the fund invests. USD5 billion was the answer.

As to liquidity, Bokor-Ingram noted that the Saudi Arabia market trades around one billion dollars a day, with some companies valued at up to USD30 to USD40 billion. "Saudi is frontier because it is under-researched and foreign investment is less than 2%," he added. "And the next lowest is Qatar, with 14% ownership. Saudi only allowed foreign ownership quite recently and we expect it to surge to 10% to 20% over the next 18 months."

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In Asia, he highlighted Vietnam, with single stocks valued at up to USD5 to USD10 billion and total trading in the market around USD250 million a day.

Currency exposure?

The long fund does not hedge but in all financial modelling and for target stock prices Fiera works on hard currency, taking account of expected currency devaluation. "In the current portfolio, it is not such a big issue because the big positions are in the Middle East where the currencies are pegged to the dollar. And in countries like Vietnam and Romania, which have much more developed currency markets, they are therefore less prone to big shocks than some of the markets that have had big shocks recently such as Argentina and Turkey."

However, as a generalisation he added that normally currency crises are a function of political or economic problems that appear before the currency devalues. "We tend to have a rule that when we see FX reserves falling significantly it tends to mean that the currency will either have to devalue or there will be capital controls and we get out of that country. We believe you will never make money investing in the best stock in a bad market."

Looking at domestic fundamentals

"Our strategy is very much focussed on what is going on domestically and it is domestic growth where you will really make the money in these countries," Bokor-Ingram reported. "In Vietnam, you have a two-tier market at the moment, with some big former state-owned companies perhaps in the oil or dairy sectors, they are liquid and that is where many people put their money, but they are they are amongst some of the most expensive stocks in frontier or emerging markets generally. However, underneath them there are a number of companies in the one- to five-billion dollar range that are going to effectively benefit from the same sort of growth path of Asia and China in the past 25 years."

Selectivity is essential

With GDP per capita surging, there is a clear path by reference to the more advanced countries of Asia that indicates Vietnam's retail market will explode with activity. "The key for us," Bokor-Ingram explained, "is that this is not complicated investing. Mobile phone shops, electronics goods, retailers, grocery stores, jewellery shops, these just require the right management and the right corporate governance. Similarly, if you look at our investments in Saudi Arabia they are not the big oil and gas companies, the petrochemical companies, they are in education, healthcare companies, which is where rising middle classes spend their money."

Governance

Bokor-Ingram highlighted the importance of corporate governance from all aspects, including respect for minority shareholder rights, appropriate dividend distributions, fairness in related party transactions, fair valuation for transactions and so forth.

"We look for companies where we can trust the management to look after our interests, in short, but we reckon that about 75% of those companies we meet do not reach the standards we expect, especially former state companies and private companies run as founder's private wealth vehicles. Over the past 30 years, we have experienced the thousand ways that money can disappear, so this is a huge focus for us in any investment that we make."

Low correlation

He also pointed to the frontier markets as an asset class that has very low correlation to emerging or developed markets. "Frontier markets tend to be driven much more by what's going on domestically than by what's going on in global markets," he explained. "And correlations between frontier markets also tend to be very low. For example, the Pakistan index over the last year is down about 60% in US dollars but that has zero impact on Saudi Arabia where you have a very positive reform process, you have an MSCI upgrade cycle and the market in the last year there is up about 20% in US dollars."

Iran? Contagion? Not really..

Bokor-Ingram was asked if Iran's troubles are a source of possible contagion of the frontier market story in the Middle East. "Two years ago," he replied, "we had 40% of the portfolio in Pakistan and Argentina, but we sold out completely as we saw what was going on in those countries, and we actually reinvested in the Middle East, where we think that what is going on in the ground is massively different from what is perceived by looking at the newspapers."

"The Iran situation is absolutely no different than it was in 2005, in 2010, in 2015," he elucidated. "Iran and Saudi Arabia will always disagree and will always vie for control of the region. There has been no actual escalation in the Middle East despite what you read in the newspapers. The only thing that has happened over the last year or so is that the US has decided to side more with Saudi than with Iran."

"Ironically," he added, "no one in the senior US administration can go there, because political ties were cut in 1979, but Iran culturally should be the USA's closest ally in the region, they are the most entrepreneurial, the most culturally free, there are even more female university women students in Iran than men. And you go to companies and more often than not the CEO or the CFO is a woman versus in Saudi zero, economically, Iran is self-sufficient, a massive exporter of manufactured goods. In Saudi it is close to zero. However, Saudi will sell the US cheap oil, and buy their weapons and buy American goods."

In conclusion to this viewpoint, he explained that the Magna team does not foresee peace in the Middle East in the foreseeable future, but in terms of what's actually going on there they have not witnessed a period of greater stability economically in the region in the last 50 years.

"Moreover," he noted, "the currencies are all pegged to the US Dollar which means that you don't have currency fluctuations. Debt levels in the countries we're investing in and US Dollar debt are lower than any other emerging market region in the world. And other countries in the region have seen what's happened in Dubai which 30 years ago was 95% dependent on oil and today has zero oil because the oil has run out but the economy is now tourism and financial services and trade."

Active vs passive?

"If you look at the performance of a lot more than 50% of frontier market funds, they have also, like us, outperformed the benchmark as well. I think in frontier markets it makes a lot of sense to have active management. These are not emerging markets which can be driven by ETF money, I personally think in frontier markets it is not even a discussion, you literally cannot invest via a passive strategy. Looking at the Morningstar performance numbers, over the last 5 years, 74% of Frontier Funds have outperformed the benchmark. I do not believe you will see this in any other equity asset class."

Africa off the radar

We are not yet playing Africa," Bokor-Ingram reported, when

quizzed by a guest. "My top-down theory on Africa is about why this population growth story is very unlikely to translate into economic growth and equity market returns. If you look at a map of Africa, it's a series of straight lines drawn up by the colonials as they were leaving Africa. In short, I don't think you really have countries based on traditional cultural and tribal demarcations, so these are not really countries in the traditional definition. Africa is very tribal, actually most regions in the world are very tribal. And the history of Africa since independence is that when a tribe gets in power it takes everything from the guys who were in power before. Long-term investment cannot thrive in that environment. Since independence started in the late 50s, no country has grown sustainably for any real period of time."

Bokor-Ingram noted that the one holding the fund has in Africa is in a telecoms company named MTN Ghana, which is a subsidiary of MTN, a South African company. "There are virtually no fixed lines and very bad banking infrastructure," he explained, "so there is massive potential."

What about China and Africa?

Bokor-Ingram explained that China's massive investment in Africa is simply self-serving. "Chinese investment in Africa is very different because it is not investment to make money out of the country, it is investment to gain access to cheap resources," he reported. "It is as simple as that. The investment story goes something like, there is a massive iron ore mine, we want to mine it, so we will build it and in return, we will build you some roads or some hospitals or whatever. In short, Chinese investment has nothing to do with development of Africa. It has everything to do with cheap resources."

Keeping eyes open

As to potential countries that might become more interesting to the Fiera team, Bokor-Ingram highlighted Kazakhstan and Uzbekistan.

"We have heard a very similar story for much of the last 20 years about attempts by the Kazakhstan government to privatise and to develop the non-oil economy," he commented. "I am actually a major sceptic, but in the past year they have been privatising banks, mining, and the airline. And although far from ideal, there are indications that there is movement towards genuine democracy, with the recent elections 77% for the long-standing president, whereas last time it was 99.5%. We have invested in the bank, which trades on a 1x book value and is generating nearly a nearly 20% return on equity and with great growth potential. We should increase our weighting in the country, if things move forward well."

Uzbekistan, a country of about 30 million people, has until the past few years been one of the most inward-looking countries of the 27 Eastern European countries that were created after the fall of the Soviet Union. "Ruled by the same leader in that time and with ongoing very strong links to Russia but virtually no links anywhere else including virtually no links to other Central Asian countries in terms of trade," he explained, "but they have now decided on a reform process, although access is very tough as there is no fully functioning stock exchange first of all and there is pretty much only one bank. However, one of our investments which is a Georgian bank is just now making an investment in the banking sector in Uzbekistan and if all goes well Uzbekistan could be very interesting. For the moment however, there is no way of investing directly, only indirectly."

A world of opportunity

By the time the discussion closed, guests had been treated to a bird's eye view of the world of frontier market investing from an expert with both the experience and track record to merit the attention the attendees clearly gave throughout the discussion. ■

Overview: Fiera Capital and the Magna New Frontiers Fund

The frontier markets discussion event that was hosted in Singapore recently by Hubbis and Fiera Capital Corporation (Fiera) was designed to focus the attention of Asia's wealth management community on the right approach to extracting returns from the many frontier markets around the globe.

Fiera itself is a leading Canadian investment management firm with a total AUM of more than USD110 billion, which promotes itself as offering thoughtful investment solutions to suit a variety of investor needs.

"Our mission is to provide clients with the highest quality of customised service and performance through a culture of integrity, teamwork, excellence, and innovation," the firm's literature states.

Fiera: stable and growing

Fiera was founded in 2003 and has been publicly-traded since 2010. The firm has over 750 employees including more than 175 investment professionals and has approximately USD108 billion under management.

Fiera is roughly 56% publicly owned, with the firm's management holding 19% and National Bank of Canada the next largest holder at 18%, as well as Desjardins Group at 7%.

Fiera in Asia

Fiera has a growing footprint in Asia, which was substantially enhanced in the USD65 million mid-2018 acquisition of Clearwater Capital Partners, a leading Asia-focused credit and special situations investment firm headquartered in Hong Kong with approximately USD1.4 billion of assets under management at the time.

Mapping the world with Magna

As to Fiera and its activities in the frontier markets around the world, the firm's representatives attending the Hubbis/Fiera discussion event stressed how experience is vital. Fiera's team that manage the firm's Magna New Frontiers Fund - first launched in 2011 and with some USD515 million under management - has that experience, in droves.

Fiera was represented at the event by lead portfolio manager Dominic Bokor-Ingram, Rick Nino, the firm's global head of distribution and Chairman of Fiera Europe, and Stephen King, head of Institutional Sales APAC.

Nino opened proceedings, explaining that he is Canadian, based in Boston, USA, from where he has developed the US practice, and delighted to be in Asia, where Fiera is intent on further developing its footprint.

He explained that the firm's Singapore office houses Stephen King who himself told the guests that his key role is to facilitate the flow of Fiera fund managers through the region, to mine down into what products clients Asian investors are interested in, and to deliver solutions.

Experience required

Bokor-Ingram introduced himself, explaining that he had joined Fiera Capital (Europe) in 2013 as part of the team focusing on frontier markets. He previously held a series of senior positions at Morgan Stanley, Goldman Sachs and, from 2006, Renaissance Capital, the EMEA investment bank operating in high-opportunity emerging and frontier markets.

He told the guests that he had been investing in frontier markets since 1992. "The Berlin Wall had come down in 1989, signalling the end of communism in Eastern Europe and equity markets started opening up with the very first equity market in the region being Hungary in 1992 moving on to Russia in 1993 and the rest of the region. Being of Hungarian parentage, that is why my interest began."

Reform the catalyst

"One of the keys I have learned over the many years is understanding how cycles happen," he continued, "and how reform processes happen, and how the markets actually emerge. That really underpins our investment strategy and how we look at frontier markets today."

"We believe there is a very strong correlation between political, economic and stock market reform and economic growth," he elucidated. "We look to invest in companies that can take advantage of this economic growth in a corporate governance structure where minority shareholders can benefit."

Excess growth beyond the EM world

"And why frontier markets?" he asked rhetorically. "Because they enjoy excess economic growth, as frontier market economies have been growing faster than emerging and developed economies. Moreover, reforms can lead to an upgrade from FM to emerging market status. Using UAE as just one example, there has been political and economic reform, a diversification of the economy, reduced dependence on oil, as well as improved regulation and liberalisation moves, encouraging capital raising and IPOs."

As lead fund manager for Fiera's "Magna New Frontiers Fund" he seeks to achieve capital growth by investing in a diversified portfolio of frontier market securities. The Magna New Frontiers Fund is a sub-fund of the Magna Umbrella Fund plc.

Seeking quality and sustainability

"We seek quality companies, with strong management and sustainable growth prospects, at attractive valuations," Bokor-Ingram explained. "Our approach to investing is bottom-up, stock-focused and research-driven. We focus on both quantitative and qualitative analysis and search for less well-understood opportunities."

"We are stock pickers," he elucidated. "Our aim is to identify well-managed companies, with robust business models where shareholder interests are respected, that can generate attractive returns on invested capital as well as sustainable growth in earnings and cashflow."

Generating alpha

He maintains that these company characteristics are not always appropriately valued in emerging and frontier markets, which often price stocks on short-term or thematic considerations.

They target a consistent management track record of capital allocation and returns, with low financial leverage, as well as attractive business models with pricing power. "We seek sustainable compound growth in earnings and cashflow, as well as requiring shareholder interests to be aligned with ours."

Management integrity vital

Regular management meetings are a key principle of the process. "We like to find companies we can invest in for the long term," he added. "Belief in the sustainability of their growth and evidence of good shareholder relations are key drivers for us. Portfolios are built based on our conviction, and if we don't like a stock, we don't invest in it, regardless of its index weighting."

"As well as extensive research trips we reach out to many industry contacts," Bokor-Ingram told the attendees. "We update a detailed company financial model for each portfolio company with meetings and on-site visits key to the process. We conducted over 600 company meetings in the last year. And valuation techniques include both relative and absolute measures."

The fund structure is UCITS, and the fund is domiciled in Ireland. Launched in March 2011, the fund has some 50 holdings currently, and a fund size of roughly USD515 million.

The fund generated a return of 5.2% (gross of fees) in April, versus an increase in the MSCI Frontier Markets Index of 0.2%. That brought the year-to-date gain to 11.3%, versus an index performance of 7.1%.

Highlights in April included the continued strong performance of the Saudi portfolio and the single largest performance was from NBD, the largest UAE bank and the largest position in the portfolio. In addition, April saw the IPO of Network International, a fintech payments company 50% owned by ENBD.

The Saudi portfolio contributed 151 basis points of positive performance in April as the following winds of reform and index inclusion continue to play out.

The only passive money to enter the market so far is from the first FTSE Index inclusion, with volumes rising from May. The Saudi market is still only 2% owned by foreign investors (as of end April) with the next lowest emerging market ownership globally at 14%.

"We therefore expect a continued positive technical underpinning to the market over the coming months," Bokor-Ingram reported. "The same positive index dynamic is being experienced in Kuwait where we expect MSCI to announce the upgrade of Kuwait to emerging market status in May or June this year, effective June 2020."

Due to the lower liquidity of the Kuwait stock exchange, this could have a more marked impact than even in Saudi. The fund as of April currently had an 18% weighting in Kuwait.

High conviction

"With very little change in the portfolio over the last six months we maintain high conviction in the earnings growth potential and the cheap valuation of the portfolio," he explained. "Earnings for the portfolio companies continue to surprise on the upside with 19% expected this year on a stock weighted basis."

As to idea generation, Magna's team seeks a flow of insights from many sources including relationships built up with local financial intermediaries over many years, as well as from competitors, customers or suppliers of existing holdings.