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Frontier markets

The wild card: Can frontier markets equities bounce back?

Frontier markets have been among the worst hit amid the coronavirus equities sell-off, but one veteran fund manager believes they have rarely offered better value.

By **Jackie Horne**
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The coronavirus spared many frontier markets from the same infection rates suffered by Western countries, but not their stock markets. In Vietnam, for example, the VN Index fell 26.1% in dollar terms during March, outpacing US benchmark indices such as the Dow Jones Industrial Average, which dropped by 13.74% over the same period.

Frontier markets are getting used to it after taking a pounding in recent years. International investors remain firmly focused on their homes markets in the US and Europe, or rapidly opening ones like China.

In the following interview, Thomas Hugger, founder and CEO of fund manager Asia Frontier Capital, argues that there has never been a better time to reconsider some of Asia's smallest stock markets. He also wishes the MSCI would re-evaulate its methodologies for upgrading or downgrading countries between its emerging markets and frontier markets index.

Hugger's Hong Kong-based group currently operates four funds with $45 million under management: its benchmark AFC Asia Frontier Fund, AFC Iraq Fund, AFC Uzbekistan Fund and AFC Fund.

Q. What impact is the coronavirus having on frontier markets? A number of stock exchanges like Sri Lanka and Jordan closed completely.

A. There’s a major difference between the stock exchange closures in the two countries.

Sri Lanka had to close because of a general lockdown or curfew, which certainly isn’t ideal, but somehow understandable since employees couldn’t travel to the exchange and operate it from there. In the future, it could happen in other countries too if a general curfew was implemented.

In Jordan's case, the Government decided to suspend trading on the Amman Stock Exchange from 17th March 2020 until further notice. We've previously had similar instances in Pakistan and Bangladesh when stock markets were closed, in these instances because of local market turmoil.

In general, such government interventions don't help the case over the short term and normally leave a lot of uncertainty and mistrust among local and international investors.

Q. Frontier market funds have had a difficult few years attracting inflows. What's the bigger picture?

A. Yes. That's absolutely correct. A number of international institutional investors have been progressively redeeming their holdings in the biggest global frontier market funds. The latter have consequently lost about a half to three quarters of their assets over the past two to three years: probably about $5 billion to $6 billion in total.

The main reason is because there's just been so much momentum in developed markets. It's impacted emerging markets as well. It's been hard to compete against the performance of stocks like Apple and Tesla.

There have also been some country specific reasons. In Asia, Pakistan had an issue with its FX reserves and balance of payments, which resulted in the IMF being called in again.

Then Sri Lanka had an issue with its coalition government, which meant the president and prime minister weren't aligned which resulted in a weakening economy and poor stock market performance

Then on top of all that there was the US interest rate cycle. One year ago, the financial markets were expecting interest rates to go up and that's always negative for emerging and frontier markets. But of course, the opposite has actually happened.

Q. What impact has all this had on your fund?

A. Our fund is now valued at 7.8 times earnings on a trailing basis. That's the lowest it's been in the eight years since it was established.

Q. So good time to buy then?

A. Yes now is definitely the time to be buying. But investor psychology is such that we received our biggest inflows when we hit an all-time NAV high and are now seeing outflows from long-term investors when it's at an all time low.

When it comes to developed market, especially the US, I still wouldn't call them cheap even now after the coronavirus sell-off.

Q. Do you expect any Asian-related adjustments to the MSCI Frontier Markets Index this year?

A. There are two major potential moves relating to Pakistan and Vietnam.

Everyone is watching to see if Pakistan is downgraded back to frontier market status again as it no longer meets the technical qualifications for inclusion in the MSCI Emerging Markets Index. Specifically, it doesn't have three stocks with a market capitalization over $1 billion.

I was in Pakistan recently and the brokers there were very surprised that they still find themselves classified an emerging markets country.

Q. Yet it was the same case last year and nothing happened then?

A. Yes it was and nobody can really understand the MSCI's methodology in this particular case

Q. So isn't there a danger that if the MSCI downgraded Pakistan, it might then have to shortly upgrade it again if the KSE-100 Index rebounds?

A. The markets are the markets. The MSCI have their criteria and they should either adhere to them or not, so at least the situation's clear.

I do think the terms emerging and frontier markets are a bit odd anyway. South Korea, for example, is still classified as an emerging market because it doesn't meet the ease or entry and exit rules for foreign investors. Yet clearly South Korea is a developed economy.

We don't really understand the MSCI's thinking especially in relation to Asia. Before Pakistan was upgraded, it constituted about 63% of the MSCI Frontier Market Asia Index.

We've now got a situation where Vietnam accounts for 85% and three individual stocks have a 14% to 19% weighting. That's not the kind of concentration risk most frontier fund managers are comfortable handling.

Q. So what's the answer?

A. I think it would help to re-think the criteria and it would also be beneficial for countries to stay frontier markets for longer, or include other Asian countries in this index like Kazakhstan.

Pakistan currently has a 0.05% weighting in the MSCI Emerging Markets index. Does it really need to be there? Does it make sense for it to be there?

Perhaps it might be better to look at a market's overall capitalization and base the criteria on that.

Q. But don't countries tend to see more inflows when investors think they'll get upgraded?

A. Yes maybe, but there's a deeper consideration. Once Pakistan got upgraded, emerging market fund managers invested in a small handful of companies to make the weighting and then just sat on them.

That doesn't help the overall market, or trading volumes. If Pakistan went back to being a frontier markets country again, it would have a bigger weighting and there'd be more diversification in the kinds of stocks being purchased.

Q. What's your overall view on Pakistan for equity investors?

A. It's actually a very exciting story. Since the IMF stepped in again, there have been improvements in tax collection, imports have gone down and exporters are being incentivized. There are a lot of good quality companies only trading at mid single-digit P/E levels.

Q. And what about Vietnam. Do you think it will get upgraded to emerging market status?

A. Yes that's the big question investors are waiting on. But I don't think it will happen for at least another two to three years. Government officials were privately acknowledging as much at a conference I attended last year.

The four top government jobs, known as the four pillars, are all up for election next year. There's the 13th Communist Party of Vietnam election in January and then a general election in May. This will decide the posts for party secretary general, president, prime minster and the chairperson of the national assembly.

So nothing is likely to happen until after that. No one at the top of the current Vietnamese government wants to take responsibility for big decisions that their successor could blame them for two to three years down the line.

There are still a number of outstanding issues Vietnam needs to clear up before the MSCI is likely to move too. One of the more minor ones is the merger of the Hanoi and Ho Chi Minh Stock Exchanges, which has been talked about for over a decade, but has yet to happen.

The big issue is the inability to trade stocks, which have reached their foreign ownership limit (FOL). There have been some positive moves though.

The government gave brokerage companies approval to launch Exchange Traded Fund (ETF), which will track shares that have reached their FOL through the Vietnam Diamond Index. This ETF is scheduled to begin trading in May.

But it's been disappointing to see how the government still doesn't seem to understand the concept of market risk. They launched the subscription period in February but gave investors no firm idea about when the ETF would start trading, or what the subscription price was. As a result, most investors have likely sat back and will wait to see how it starts trading first.

Q. What about Vietnam's neighbours? There's been a fair bit of activity from Cambodia, Laos and Myanmar lately.

A. They're all interesting, but I don't think they'll classify for the MSCI Frontier Markets Index for a few years yet. Cambodia will have one billion dollar company once ACLEDA Bank lists, but neither of the other two exchanges has one yet.

What's good is that all three have partnered with sophisticated stock exchanges to get technical advice: the Yangon Stock Exchange with the Tokyo Stock Exchange while the Laos Securities Exchange and the Cambodia Securities Exchange have teamed up with the South Korean Exchange.

These partnerships have given the three exchanges the right trading software, plus a good grounding from a legal and compliance point of view. That's all great and the South Korean Exchange running the Laos Securities Exchange, in particular, has done an excellent job there.

But I think it's also important to think about where these countries are in their stage of development. Cambodia was in the dark ages two decades ago, so it's important not to import standards that a country just isn't ready for.

For example, even Tesla doesn't make a profit yet and it's one of the biggest companies in the world. The same was true for Amazon for many years. So why do these exchanges require more stringent profitability rules compared with more developed exchanges?

Q. What's your view on the ACLEDA Bank IPO?

A. What's happening in Cambodia is very exciting. ACLEDA Bank is very well run institution, having built itself up from a DFI-funded microfinance institution into a fully-fledged commercial bank. It has a very good management.

ACLEDA Bank was our biggest and best holding when I was a partner at Leopard Capital, and Asia Frontier Capital was spun off later. It was always our biggest and best holding at Leopard Capital. We purchased our ACLEDA Bank stake at two times price to book at that time.

Q. The timing of the IPO has been a bit unfortunate.

A. Yes. Last year, Cambodia was one of the world's best performing stock markets. During the first two months of this year, it started heading in the other direction: down 15% in January and 8% again in February, although it recovered thereafter.

I think the economy has had a very good run over the past five years. Property prices have shot up a lot because of Chinese investments. The economic outlook is still good, but not as great as it was five years ago and the sanctions announced by the EU in March 2020, plus COVID-19 are not helping either

Q. What about Myanmar? The Yangon Stock Exchange started allowing foreigners to trade shares in March.

A. That's certainly a good development and one that we've been awaiting for some time. The country is on a different scale to Laos and Cambodia because of its larger population. It also has an abundance of natural resources, diversified industries and great tourism potential.

The big downside is that certain funds cannot invest there for ESG reasons at the moment. Unfortunately it's very cumbersome to start trading there since a local bank account is required which can only opened by physically visiting a bank in the country.

The market has also improved last year from $334 million in February 2019 to $425 million today.

Q. What difference do you think foreign investors will make?

A. It could follow a similar trajectory to Vietnam, which went nowhere for a number of years. The tipping point normally comes when an exchanges has continuous investment by both retail and foreign investors. As long as economies grow, the stock market eventually catches up sooner or later.

Q. What's your view on Bangladesh?

A. We like the country from a bottom up perspective. It's a significant beneficiary of the trade war and it has a hardworking population.

The problem lies with the government. Last year, it interfered in the financial system by capping the interest rates, which banks could lend at. Since April 1, there's a 9% cap.

Q. Why's that a bad idea?

A. Because the government is paying 11% to depositors that invest via post office accounts. Those same investors can then go and borrow money at 9%. The banking system is working upside down: they are supposed to make a spread between what their deposits and loans. It hits also the profit margins of all banks and financial institutions severely.

There was also the $1.5 billion demand for unpaid taxes against Telenor's Bangladesh subsidiary Grameenphone, which has hardly inspired interest.

Q. Any other Asian countries you have a strong view about?

A. Yes, Uzbekistan. Under President Islam Karimov it was run on the worst Soviet model – gulags, lack of press freedom, closed borders. He was in power since 1989, but died unexpectedly 2nd September 2016.

The new president (and former prime minister) Shavkat Mirziyoyev announced in February 2017 that he wanted to turn the country by 180 degrees. If someone like North Korea's Kim Jong-Un said that or did that, then it would be a sensation and they eyes of the world would be on him.

But unlike North Korea or Cuba, Uzbekistan has been completely overlooked by investors and the international press. It's not getting the attention it deserves.

But it has a well-developed stock market with 100 companies and is also partly owned by the South Korean Exchange. Many good companies are only trading at two to three times P/E.

I suppose investors want to make sure that recent changes are for good. There's also a bit of bureaucracy involved in terms of opening a trading account. Then there is the familiar bugbear in frontier markets. There are no foreign custodian banks. But we're very positive on the development of the country and the stock market.

Q. Any final advice?

A. We live in volatile times and people associate frontier markets with volatility. But actually, our volatility is lower than the MSCI World Index. We're active managers so we get out ahead of crises and frontier markets typically have low correlation with developments around the rest of the world.

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