

INVESTING: MAKING YOUR DOLLARS WORK FOR YOU

INVESTING IN FRONTIER MARKETS

The term “emerging” market was coined in 1992. **A Frontier market is a smaller, low liquidity version of an emerging market.** Emerging markets are those that haven’t quite evolved into developed markets. China, Russia, and India are the larger examples of emerging markets.

Some examples of frontier markets include: Argentina, Croatia, Jordan, and Romania. These markets aren’t necessarily in small countries, but their financial markets haven’t yet reached the emerging market classification yet.

Frontier markets can provide excellent investment opportunities. From February 2013 to June 2014, frontier markets are up roughly 32%! However, the companies in these markets tend to be considerably smaller than in developed markets and have far less liquidity.

Investing in frontier markets is a great way to diversify your portfolio. **The Journal of Portfolio Management found that**

frontier market investments offer the greatest risk reduction to portfolios concentrated in international investments.

That's something to consider if you already have foreign investments.

▶ **HOW TO INVEST IN FRONTIER MARKETS**

Investing in a foreign market is actually quite easy. However, investing in a particular foreign stock can be tricky in some cases. Some of the methods make more sense for the average investor.

There are several options available if you wish to invest in frontier markets:

1. **Exchange-Traded Funds.** An ETF tracks a specific stock index, yet trades like a stock. The portfolio is designed to mimic the return and yield of the target index. When you purchase shares of an ETF, you're buying shares of that portfolio.
 - ▶ This is a great way to maximize your diversification while retaining the simplicity of a stock.

- ▶ Be aware that many of the emerging markets have less total value than the company Apple. ***Being well diversified isn't necessarily the same as owning part of a large market.*** Keep your eye on the size of the market.
 - ▶ ETFs are quite inexpensive, since the investment doesn't require active management.
 - ▶ ***For most investors, exchange-traded funds are likely to be the best investing vehicle for frontier markets.***
2. **Mutual Funds.** There are both closed-end and open-end options. Closed-end funds require another investor to purchase your shares, and the number of shares is fixed. That also means that you'll have to purchase your shares from another investor.
 3. **Buying Individual Stocks via ADRs.** American depository receipts represent shares in non-US stocks, but are available on US stock exchanges. For example, if you purchase shares of Toyota, you're actually purchasing ADRs.
 - ▶ A small percentage of frontier market stocks are available through depository receipts. You might be lucky

and find what you're looking for. Performing research on these stocks can be tricky. Not only is there a potential language barrier, but you must also attempt to find reliable financial information.

- ▶ Each ADR can represent a single share, several shares, or a mere fraction of a share.
- ▶ ***ADRs are much more convenient than investing on a foreign stock exchange.***

4. **Buy stocks directly on a foreign stock exchange.** For many foreign markets, it's possible to purchase shares through your US brokerage account. For frontier markets, this is rarely possible. ***This is rarely recommended unless the investor is quite sophisticated and of high net-worth.***

- ▶ The fees can be significant. Unless you're purchasing a lot of shares, you're already well behind.
- ▶ Currency issues. There are always currency risks with foreign investments, but you'll have to exchange your money both ways eventually. Exchanging currency always has a cost.

Consider taking advantage of exchange-traded funds when investing in frontier markets. Over time, these seem to be the best bet for most investors. Attempting to successfully pick individual stocks in a frontier market has proven challenging to both amateurs and professionals.

▶ **AVOIDING THE RISKS THAT FRONTIER MARKETS PRESENT**

In nearly any financial endeavor, there are risks that need to be mitigated. ***Simply being aware of these risks can be helpful in avoiding significant losses.***

With the opportunity for rapid growth, there is also volatility. Volatility can work both ways. It permits for both rapid gains and rapid losses.

Frontier markets typically lack the financial safeguards that exist in better-established markets. These safeguards are most often found in the areas of financial reporting. It's not easy to get all the numbers required to make sound financial decisions.

Avoid these risks:

1. **Frontier markets are especially sensitive to geopolitical issues.** How stable is the country that contains the financial market of interest? If there's more than one target country, how stable is the region? ***It only takes one significant political or social issue to send a smaller market into a potential tailspin.***
 - ▶ Also consider the other countries that do business with your frontier market. Challenges there can also be an issue.
2. **A lack of liquidity is an additional concern.** Smaller markets usually mean fewer buyers and sellers. When it's time to sell, it might be challenging to find a buyer. The only real solution is to wait or take a lower price.
3. **A lack of diversification in mutual funds.** Many mutual funds that specialize in frontier markets are less diversified than other types of funds. A lack of diversification can increase the amount of volatility experienced. ***Be sure to take a look at the fund's holdings to determine if the investments are spread around adequately for your tastes.***

All investments have at least some risk. Being aware of the risks found in frontier markets will improve the odds of your decisions being wise and fruitful.

▶ CONCLUSION

Frontier markets are simply small emerging markets with low liquidity. Frontier markets have the potential to evolve into emerging markets. ***These markets are both high reward and high risk.*** The risks can largely be mitigated with the proper understanding.

If you take the time to study frontier markets and investments, there is a lot of potential upside. It's important to monitor your investments and keep your eye on the international news. There is certainly more risk in a frontier market index fund or ETF than in a similar investment in the United States.