Frontier markets offer significant rewards, but with a

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Frontier markets can offer big opportunities for investors, but those who roll the dice on these less-developed regions need to have an appetite for the bigger risks that could come with the search for potentially lucrative rewards.

Frontier markets are the poor cousins of emerging markets – such as China or India, which have stronger, more stable and often thriving economies – and at the other end of the spectrum from developed markets such as the United States, Canada or Western European countries.

“We’re talking about countries whose capital markets are even less developed [than emerging markets]. For example, [frontier markets include countries such as] Argentina, Pakistan, Nigeria and some of the countries in the Middle East,” says Michael Dorfman, managing director and portfolio manager with the Dorfman Group at BMO Nesbitt Burns Inc. in Toronto.

There’s no standard definition that puts particular countries in fixed categories, he notes.

Although there’s no set rule on how to define a specific market, FTSE Russell classifies countries as developed markets, emerging (either advanced or secondary) markets or frontier markets based on a score it assigns using a range of criteria.

Countries that make it onto the list as frontier markets must meet five criteria: They must have a formal stock market regulator; no significant restrictions on repatriation of capital; a “rare occurrence” of failed trades; they need to clear and settle trades within five days of a transaction – or better; and they must have a timely trade-reporting process.

By these standards, some countries fall below the threshold for investors interested in frontier markets.

Mr. Dorfman notes, for example, that countries such as Cuba or Venezuela would still be considered beyond the frontier. The allure of frontier markets is that they offer an opportunity for investors to take advantage of certain countries’ rapid economic growth, says Neville Joanes, chief investment officer at Vancouver-based robo-adviser WealthBar Financial Services Inc.

“There’s a sound investment thesis for gaining long-term returns from frontier markets,” he says.

But investors also must weigh the significant risks. In fact, political risk should be the first consideration even for investors who are considering relatively stable and promising frontier markets, Mr. Joanes says.

“We are not in the most supportive environment right now to maximize those returns,” he warns. “The current global environment of pro-nationalism and trade wars creates a level of uncertainty that has a greater impact on both emerging and frontier markets than on developed ones.”

Usually, the political risk in a frontier market drives the economic risk. Some countries may fall far short of being full democracies but still stable economically. Investors should watch out for

those “with a political system that is highly corrupt or in which the policies actually inhibit growth. Those are huge problems,” Mr. Dorfman says.

Nevertheless, risk is the name of the game when it comes to frontier markets, he adds: “The key in this field is: more risk, potentially more return. “There are many who believe, for instance, that today’s Vietnam is tomorrow’s China.”

But picking individual frontier markets to invest in is especially risky because of the way many of their markets are structured, he adds.

“Many of these countries’ markets actually have very few listed companies traded publicly that you can invest in,” Mr. Dorfman explains.

In addition, the companies that do trade in frontier markets are often those in which the business is tied closely to – or even partly owned by – the local government.

“They might be public utilities, or telecommunications or infrastructure companies that are not necessarily entirely private – and they’re not always run without government interference,” Mr. Dorfman says.

Instead, investors can gain exposure to frontier markets with mutual funds or exchange-traded funds (ETFs). Some track indexes of stocks from a particular frontier market; others track a basket of frontier markets; and others still offer a mix of frontier and emerging-market holdings.

“It’s particularly risky to buy into individual companies in a frontier market unless you have particular knowledge about that company,” Mr. Dorfman says. “Most investors are going to want to look to a pooled investment – either one that’s based on a particular country or one with a more broad-based pool. An investor who has an affinity to a particular country, maybe by culture or background, might buy an ETF for that country. But, otherwise, investors would probably prefer a pool, to avoid what’s called ‘single-country risk.’”

Investors do need to be aware that frontier markets tend to be more volatile than emerging or developed markets. The MSCI Frontier Markets Index, which comprises large- and mid-cap holdings from 28 frontier market countries – including Kuwait, Vietnam, Morocco and Nigeria – is one of the best-known benchmarks: it rose by 32.3 per cent in 2017 and dropped by 16.2 per cent in 2018.

Frontier market investments can help diversify a portfolio, but investors should be aware that “the enhanced risk and the possibility that the timelines for growth might take long,” Mr. Dorfman says.