Investing in frontier markets can come with a high degree of volatility yet can also offer exciting potential. Some of yesterday’s small agrarian economies have transformed into today’s global powers—China is the most impressive example. Depending on how you crunch the numbers, China represents the world’s second-largest economy, and incredible changes have taken place there during our lifetimes. Indeed, China is one of several countries that until recently were viewed as largely risky or even untouchable for investors and travelers alike but today are being discussed as interesting potential destinations for both.

Here are some examples of countries that until recently have been shunned or out of favor but have undergone big transformations. Included are emerging and frontier markets of great current interest, as well as countries we are not investing in yet but that are opening up to investors.

Countries Where We Already Invest

China

Annual trade between the United States and China was roughly US$200 million in 1950, before the United States placed an embargo on China that lasted until 1971. Today, annual trade between China and the United States exceeds US$500 billion, making China the United States’ second-largest trading partner (Canada is the first). China has undergone huge growth over the past three decades and has transformed its economy. For emerging-market investors, China is a destination that cannot be ignored—it is an engine of growth for the world. Even if market watchers must become accustomed to slightly slower gross domestic product (GDP) growth than in the past years, we think the 7.4-percent growth rate China reported in 2014 and the target of about 7 percent in 2015 still look impressive given the size of China’s economy. Deceleration of China’s percentage growth rate doesn’t worry us because the country’s economic base is expanding even at lower-percentage growth rates, and the amount of money added to the economy could continue to expand as well.

Japan

Japan is an example of a country that moved rapidly from frontier- to emerging- to developed-market status. Today Japan is one of the strongest trade partners of both the United States and Europe. Japan’s rise to economic strength after World War II has been a great achievement, and its high-quality, high-tech goods have permeated nearly every corner of the globe. Since its 1980s boom times, Japan’s economy has stagnated some, but it still holds plenty of sway in the world’s economy. Its government has been working to increase consumption and jump-start growth through an ambitious, three-pronged fiscal and monetary approach. In our view, the Bank of Japan’s quantitative easing regime that began in 2013 and is continuing today should help support global liquidity and trickle down to emerging markets in the region.

South Africa

Apartheid, South Africa’s system of legalized racial discrimination, cast a shadow on the country in the eyes of the international community. The United Nations and the United States both imposed sanctions, resulting in the withdrawal of many large multinational companies from South Africa in the 1980s. The end of apartheid in South Africa in 1994 opened the door to investment in the country, but since then the South African economy has been struggling to reach full potential.

South African stocks started 2015 on a solid note, aided by the recent drop in oil prices. Retail businesses, particularly food and clothing, seem to be benefiting from a boost to domestic consumption due to lower fuel prices. South Africa has been struggling with an electricity crisis that may stunt GDP growth this year, but we continue to believe that attractive long-term investment opportunities exist across a range of South African markets and sectors.

The government has focused on redistribution of wealth and extensive social grants, so companies that provide goods and services to consumers at the low end of the income scale have benefited tremendously and, in our view, should continue to do so. Also, many South African companies that generate a substantial portion of their income from operations and investments in other markets have benefited from a weakening of the South African rand relative to the U.S. dollar and other major currencies. The real-estate sector has been stable with price

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growth in recent years, fueled by demand that substantially outstrips supply, especially at the entry level. In this regard, the financial sector plays a key role, with banks taking a fairly conservative approach to both asset-backed and non-asset-backed lending activities. Moreover, a number of South African companies are investing on the rest of the African continent across a variety of industries including infrastructure, retail, financial services, and telecommunications.

Countries That May Be Good Future Investments

Here are three examples of frontier markets that have been out of favor but are transforming and opening up to wider foreign investment. These three are just a sample of the markets we are watching for potential future opportunities. To do business effectively in a country, we believe it’s important to understand the culture and the people, and we do that by studying the country and traveling there to talk with ordinary citizens as well as government officials and business leaders. Of course, understanding the culture and people then leads us to understand the legal structure both in terms of what is written and how laws and regulations are actually applied, which is of critical importance. Our visits to Vietnam have been quite exciting, a recent visit to Myanmar has left us inspired, and my trip to Cuba a number of years ago really excited me as to the potential in that market.

Vietnam

Since the end of what Americans call “the Vietnam War” and Vietnamese call “the American War,” Vietnam has experienced huge change. Vietnam’s rise hasn’t been as powerful or fast as Japan’s post-WWII experience, but a construction boom has been underway. In 2010, Vietnam got its first skyscraper, the striking Bitexco Financial Tower, which stands as a beacon in Ho Chi Minh City. An even taller building now under construction is expected to rise to about 350 meters and host a luxury hotel, apartments, shopping, and Southeast Asia’s highest restaurant and bar. (Our Templeton Emerging Markets Group has an office in Ho Chi Minh City, and it’s exciting to visit.)

Vietnam’s middle class has been growing and people have been trading bicycles for motorbikes, scooters, and automobiles. To help alleviate the traffic on busy city streets, Vietnam’s first-ever subway system has been under construction with the help of foreign investment from Japan, France, and China.

Figure 1 illustrates Vietnam’s eagerness for new technology: Growth in mobile phone subscription rates in Vietnam topped even India and the United States during 2002–2012.

The progress is clear, but Vietnam’s transformation has been slower than we’d like. The French colonial period and the war left people sensitive about foreign dominance, and foreign investment is thus often treated with suspicion. But the Vietnamese seem to be gradually overcoming these reservations because of the positive developments they see to the north in China, and we recently have observed signs that Vietnam is allowing greater foreign investment. Vietnam’s stock market is not very liquid, and it is considered a frontier market; but Vietnam has had a fast-growing economy, and we have found good companies there, including some that are state-owned.

Myanmar

Myanmar is a perfect example of the next frontier of untapped markets that is going through big changes in policy and local perceptions. On a recent visit, we toured Mandalay, a city in a true time warp, and Yangon, with its skyscrapers and other modern developments. Growth in Myanmar has been robust: GDP growth was more than 8 percent in 2013 and 2014 and is expected to keep a similar pace in 2015. However, Myanmar’s capital markets have a long way to go before we can consider investing there in a meaningful way. Elections in November 2015 could have a big impact on acceptance by the United States and other countries that have had embargoes and other constraints to doing business there. During our visit, our team met with officials who are planning a stock exchange, and clearly it will take some time to develop the financial system infrastructure necessary to support foreign investment.

Cuba

We are not yet able to invest in Cuba, but we are watching closely. A new chapter in Cuba-U.S. relations, including the restoration of diplomatic ties between the countries and the possible end to decades of U.S. sanctions, is generating lots of excitement. The U.S. Department of State has indicated that it aims to lift restrictions on travel, commerce, and financial activities with Cuba. However, with a Republican-controlled Congress and a strong anti-Castro Cuban diaspora that still holds some influence in the United States, rapid progress seems unlikely unless there are more signs of democratic reform in Cuba.

Figure 1: Growth in Mobile Phone Subscriptions (2002–2012), Emerging vs. Developed Markets

<table>
<thead>
<tr>
<th>Country</th>
<th>Subscriptions per 100 people</th>
</tr>
</thead>
<tbody>
<tr>
<td>Vietnam</td>
<td>1,412%</td>
</tr>
<tr>
<td>India</td>
<td>5,691%</td>
</tr>
<tr>
<td>Indonesia</td>
<td>95%</td>
</tr>
<tr>
<td>Russia</td>
<td>73%</td>
</tr>
<tr>
<td>U.S.</td>
<td>6,307%</td>
</tr>
<tr>
<td>Japan</td>
<td>1,999%</td>
</tr>
</tbody>
</table>

Source: World Bank, World Development Indicators April 2014; based on percentage change in mobile cellular subscriptions per 100 people.
Nevertheless, it seems obvious there will be opportunities for airlines to add flights to the island following the relaxation of travel rules, and we’ve already heard from a few U.S. carriers eager to add or expand service to Cuba. U.S. banks may benefit because U.S. tourists will be allowed to use credit and debit cards in Cuba, and the U.S. bank accounts of Cuban residents will be unlocked. The maximum annual U.S. remittance to a Cuban national is increasing from US$2,000 to US$8,000, but unless the 1962 embargo is lifted, U.S. investment into Cuba will remain severely restricted.

The impact on U.S. firms from the new relationship with Cuba likely will be limited in the short to medium term, but gains for non-U.S. firms could be substantial. Cuba’s ability to access the U.S. market could make investing in export-oriented Cuban enterprises more attractive for non-U.S. firms. If the embargo is lifted, then Cuban companies that escaped to the United States after the revolution could return and relocate there. The Castro government’s grip on the economy remains a barrier to wider investment, but there are some signs it could loosen, and food may become the first item of trade to be liberalized. The U.S. Agriculture Coalition for Cuba, which includes about 30 U.S. companies and food-related groups headed by an executive of a U.S. food giant, has been lobbying Congress to lift the Cuban trade embargo.5 Despite the obstacles, we think the long-term opportunities for potential investment in Cuba look enormous.

Frontier Markets General Outlook

These are just a few frontier markets we are watching—we also are excited about many more. We believe the structural reasons for frontier investing remain generally solid; these reasons include good potential growth rates, strong domestic and capital markets growth, technology transfer, demographic advantages, and generally low sovereign and private indebtedness. Of the 10 countries estimated by the International Monetary Fund (IMF) to have achieved the fastest economic growth between 2003 and 2014, eight were frontier markets; China and India were the other two (see figure 2).

The underlying growth profile in frontier markets can be particularly attractive because these markets tend to be more exposed to their domestic economies—many of which are developing rapidly—as opposed to the global economy, which is growing at a slower pace. Furthermore, advantages of technological advancements, leapfrogging over the development phase, and partnerships between emerging markets (which are able to supply capital and technology, such as China) and frontier markets (which have low labor-cost structures), could be particularly potent sources of growth.

A number of countries are undergoing positive developments and headwinds remain for others. Headlines of conflict and tension in some emerging and frontier markets continue to affect overall investor sentiment. At the same time, an improving macro environment and lower political risk have benefited individual economies (e.g., Sri Lanka and Bangladesh). As of press time, major world powers continue to discuss and debate a United Nations Security Council resolution to lift sanctions against Iran. Meanwhile, planned economic reforms and a new IMF loan program could further promote Pakistan as an investment destination.

We don’t know what the future will bring, but we do know that active management with on-the-ground research and a bottom-up stock selection process is critical when investing in frontier markets.

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Endnotes

2. Source: U.S. Census Bureau, 2013 data.

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What Are the Risks?

All investments involve risks, including possible loss of principal. Foreign securities involve special risks, including currency fluctuations and economic and political uncertainties. Investments in emerging markets, of which frontier markets are a subset, involve heightened risks related to the same factors, in addition to those associated with these markets’ smaller size, lesser liquidity, and lack of established legal, political, business, and social frameworks to support securities markets. Because these frameworks are typically even less developed in frontier markets, as well as various factors including the increased potential for extreme price volatility, illiquidity, trade barriers, and exchange controls, the risks associated with emerging markets are magnified in frontier markets.

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