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FUNDAMENTALS OF INVESTING

Brave New Stocks

Fund firms broaden their horizons as India, Brazil and China become yesterday's news. The quest: markets that zig when the U.S. zags.

By [SAM MAMUDI](#)

Many mutual-fund investors have gone overseas to diversify their portfolios and boost performance. But so far this year, markets in Europe and Asia have only brought investors more of the same losses they're getting at home.

Emerging markets have been particularly disappointing. Favorites such as Brazil, Russia, India and China have tumbled hard, in part due to recent falls in commodity and oil prices, making it painfully clear that even these countries don't offer as much diversification as investors had hoped.

Yet one group of countries is redrawing the map. Some budding economies of the former Soviet Union, Africa, the Middle East and the least-developed parts of South America and Asia have been marching to their own beat.

"Many emerging markets have been picked over in terms of interesting ideas," says David Riedel, president of Riedel Research Group, an independent stock-research service focused on emerging markets. "Investors looking for significantly mispriced and undervalued opportunities need to look farther afield."

Such frontier markets -- so-called because they sit at the edges of the investment world -- have delivered better returns so far this year than emerging markets overall. While the MSCI Emerging Markets Index lost 32.1% this year through the middle of last month, the MSCI Frontier Markets Index was down 23.5%. The Standard & Poor's Frontier Markets Index has outperformed other key indexes, including the U.S.-rooted Standard & Poor's 500-stock index, over the past 10 years.

Such results haven't been lost on providers of mutual funds and exchange-traded funds. Some big fund companies have been bringing out a variety of frontier-markets vehicles that offer small investors a way to participate in alternative investments that typically have been pursued by large institutions

and wealthy individuals. Even T. Rowe Price Group Inc., a company known for its conservative approach to new products, has an offering: T. Rowe Price Africa & Middle East Fund, which was introduced about a year ago. Recent top holdings included Commercial Bank of Qatar and Dubai Financial Market, the Dubai stock exchange.

"People looking for assets that behave differently from the majority of their portfolios can find that in frontier markets," says Christian Magoon, president of Claymore Securities, which in June introduced a frontier-markets ETF, [Claymore/BNY Mellon Frontier Markets](#).

Gregg Wolper, senior fund analyst at research firm Morningstar Inc., says frontier-markets funds can be appealing for "more adventurous investors with long-term horizons."

The Final Frontier

Countries on the investment frontier can be thought of as "emerging emerging markets" -- just beginning to get their economic houses in order. China 20 years ago would have been a frontier market, for example. Today's hopeful successors include Nigeria, Peru, Oman and Vietnam.

Frontier-markets investors are banking on that transformation becoming complete, says James Upton, senior portfolio specialist for the [Morgan Stanley Frontier Emerging Markets Fund](#), a pan-frontier-markets mutual fund that began trading in late August.

The fund follows stocks of 32 countries in which it can trade locally. As well as the bigger names of the Middle East and Asia, the list includes Jamaica, Trinidad and Tobago and several Eastern European countries, including Bulgaria and Ukraine.

Mr. Upton says he looks for countries whose economies are growing "well above" 5% a year that also have "a spirit of reform and transparency." Nigeria, for instance, has a population of 150 million, but just 10 million have bank accounts. "It's like investing in Brazil or Poland 10 to 15 years ago," he says.

Much of frontier markets' growth is expected to come from industries that have boosted other emerging markets, he says. As emerging economies mature, wages and other costs rise; frontier markets are a cheaper substitute. For instance, Bangladesh is poised to take the contract drug-manufacturing business from India; manufacturing plants are relocating to Vietnam from China.

Ironically, investing along the frontier often bypasses the products for which these countries are known. For example, the best opportunities in the Persian Gulf aren't in oil, Mr. Upton says. Oil is a commodity and the companies in that industry are mostly based outside of the Middle East; oil and energy-materials

companies only account for 10% of Gulf states' markets.

But oil money fills the Gulf states' coffers. "Infrastructure spending is set for years to come," Mr. Upton says. In addition to construction, other promising sectors in the region include telecommunications and financials.

New Funds, New Markets

If you're thinking of stalking the wild frontier, you can travel several investment routes.

The Morgan Stanley fund is a closed-end fund, meaning that the fund's shares were sold in an initial public offering, and you buy them now through the New York Stock Exchange, purchasing from investors looking to cash out.

The Claymore ETF spans continents, but about half of its money is invested in Poland and Chile, which aren't exactly on the fringe. The ETF has a substantial presence in Egyptian banking, telecommunications and construction companies, along with stakes in Pakistan's [MCB Bank](#) and Peruvian mining giant Buenaventura Mining Company Inc.

"People aren't looking for today's best investment opportunities, but for tomorrow's," says Claymore's Mr. Magoon. He calls frontier markets the "babies of the world markets."

Other funds and ETFs offer more targeted, regional access to these nascent markets.

Africa is a major beneficiary of frontier investment activity. An ETF, [Market Vectors Africa](#), from Van Eck Associates, recently had positions in myriad companies, including South African gold and mining interests, Nigerian banks and breweries, and London-listed Orascom Telecom, a leading Egyptian telecommunications firm.

The Middle East is also attracting buyers' attention. Besides the T. Rowe Price Africa & Middle East Fund, there is [PowerShares MENA Frontier Countries](#), which invests mostly in Kuwait, the United Arab Emirates and other parts of the Middle East. Other ETFs dedicated to the region include Market Vectors Gulf States and [WisdomTree Middle East Dividend](#).

Danger Spots

As with any investment offering high rewards, there are risks -- principally the lack of liquidity in frontier markets. These markets see far less trading activity than other economies, and that can be a big problem for investors.

Because frontier markets are small and stock trading is not widespread, mutual-fund managers may not be able to find a buyer for their holdings. This means it can be hard to get out of a bad-performing or falling stock.

Morningstar's Mr. Wolper says frontier markets also are fraught with political and currency risk, as well as a lack of regulatory oversight in the countries where they are based. A good alternative for many small investors is a broad emerging-markets fund that also plies frontier markets, such as Lazard Emerging Markets Equity Fund, he says.

"You need to have a view ahead for five, 10, even 15 years," adds Mr. Riedel of Riedel Research. "If you have a long time horizon," he says, "these societies and economies will join the world economy in a more integrated way, and the benefits to shareholders will flow through."

—Mr. Mamudi is a reporter in MarketWatch.com's New York bureau. He can be reached at SMamudi@MarketWatch.com.

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