

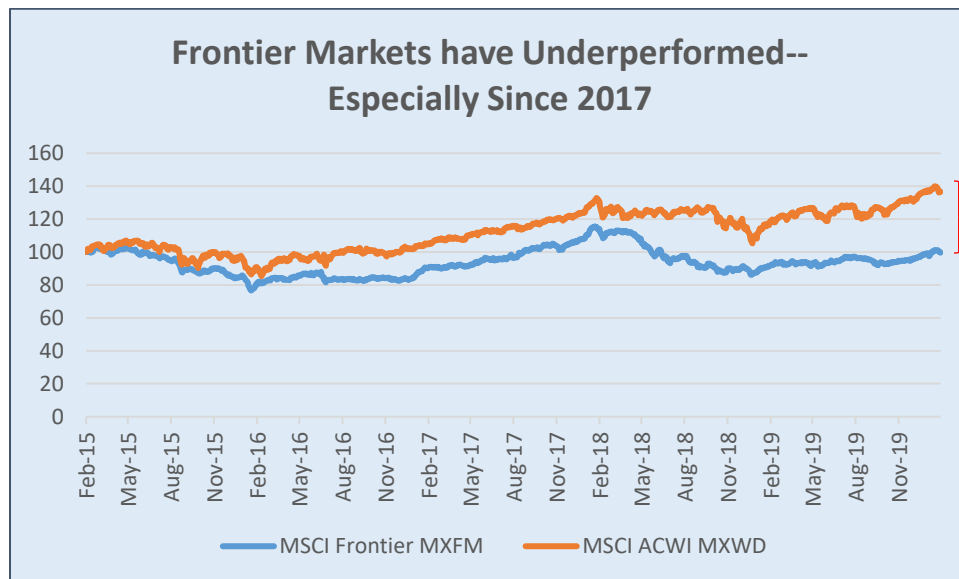
Kyklos Capital

OUTLOOK: Time for Some Mean Reversion?

"If something cannot go on forever, it will stop." Herb Stein

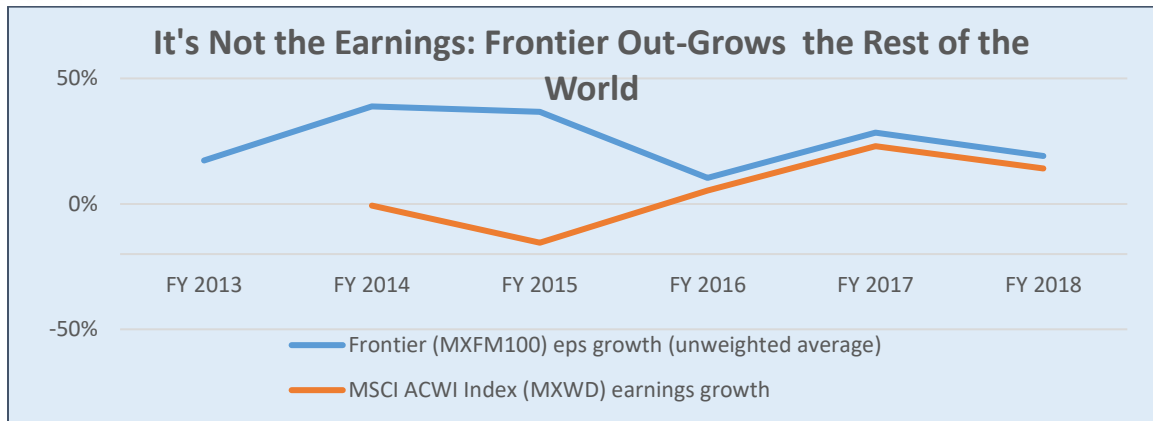
Frontier markets slightly outperformed other market categories in January, but they have mostly underperformed over the past two years. Frontier valuation multiples are attractively low. The question, of course, is, "When will it stop?" If Frontier underperformance is part of a normal cycle, it will return to average levels-- known as "mean reversion"-- which would imply that today's conditions in Frontier are a big investment opportunity. On the other hand, if there is a permanent, structural explanation, then Frontier is "cheap for a reason," and the discount could continue indefinitely. Kyklos sees opportunity-- here's why.

1. *Frontier has underperformed significantly since 2018 (comparing the MSCI Frontier Markets Index MXFM, and MSCI ACWI which includes Developed and Emerging markets):*

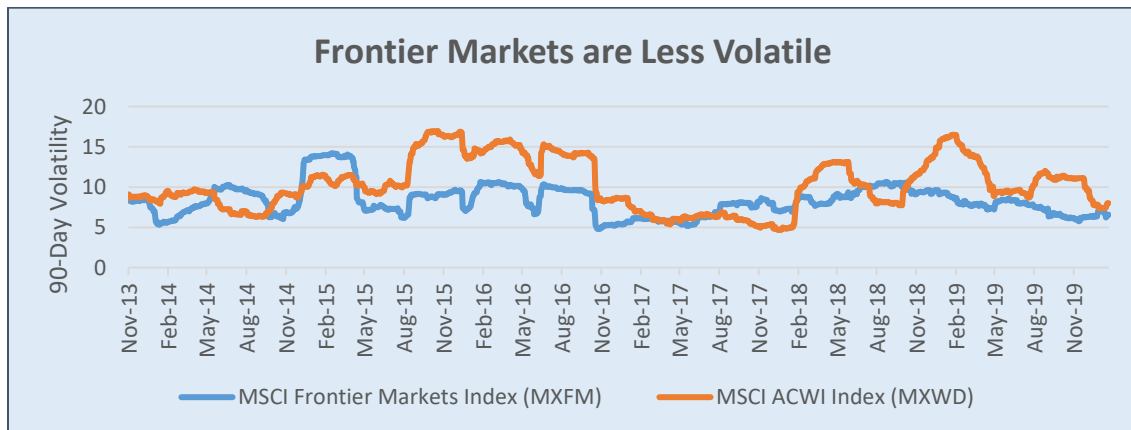


The recent
gap in
performance
is widening

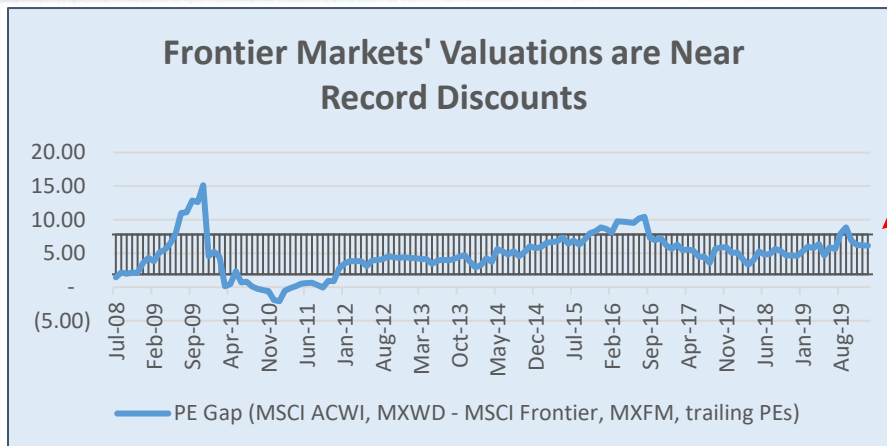
2. *The two traditional explanations for underperforming markets are that earnings growth is lower, or risk is higher, or both. Neither is true here. Frontier company earnings continue to **grow faster** than those in the rest of the world...*



... and risk continues to be lower for Frontier markets than the rest of the world (as measured by volatility).



- As a result, the discount on Frontier equity valuations is now exceptionally high, and is currently near a full standard deviation cheaper than long-term averages, a level that is rarely surpassed.



4. *Our best explanation for recent underperformance by Frontier markets is **foreign investor selling pressure**.*

There is little doubt that foreign investors in Frontier markets have been selling, as can be seen in the eroding assets of Frontier mutual funds¹. More is at play than simple negative momentum in share prices. As index-chasing by ETF, quant and passive investors has increased, the role of index decisions by MSCI is more important-- in effect, MSCI has taken on the active decisions traditionally done by portfolio managers. This has meant that many of the largest, most attractive, and most liquid Frontier country stock-markets have been removed from the main benchmark, the MSCI Frontier Markets Index (MXFM), eating away at the Frontier investor base and sucking trading liquidity from the other Frontier countries before transferring it into the Emerging markets group. Institutional investors flee markets with declining trading volumes, widening valuation discounts.²

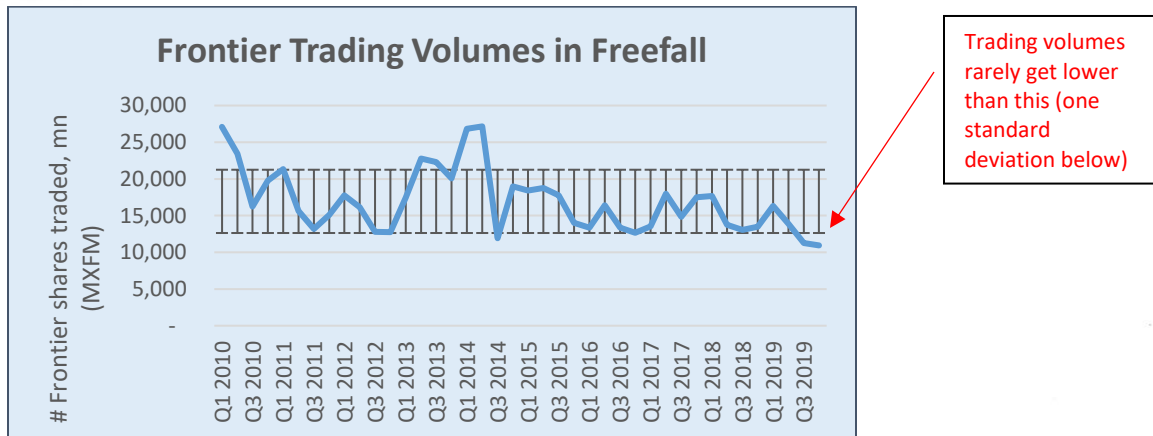
The damage done to Frontier trading volumes over time (below), after MSCI's steady removal of top-weighted countries Egypt, Qatar, UAE, Pakistan, Argentina, and soon Kuwait from the Frontier index, explains much of the climbing valuation discount. **The new news in 2020, we think, will be a pause**, as the remaining Frontier candidates for MSCI changes look limited. Vietnam, the obvious next-in-line, features dire foreign ownership limits, account requirements and trading restrictions that will block changes to their status for now. Without MSCI's intervention, we look to fundamental factors to drive returns in 2020, and liquidity to stabilize or improve.

1350 Avenue of the Americas
2nd Floor
New York, NY 10019
t: 646.738.8078
cgushee@kykloscapital.com

¹ See <https://www.barrons.com/articles/frontier-markets-are-on-sale-but-it-could-be-a-wild-ride-51563449400> , amongst many examples covering Frontier outflows.

² <https://www.nber.org/papers/w23557.pdf>

Kyklos Capital



5. Depository Receipts provide more evidence that Frontier's underperformance is due to foreign selling.

Depository Receipts (DRs, such as ADRs or GDRs) are issued by Frontier companies and listed in markets such as London or New York, to allow foreign investors who are unwilling to trade in the local markets to become shareholders. If Frontier underperformance were specifically caused by foreign investor selling, then Frontier DRs as a group would likely underperform locally listed shares. As Frontier fund outflows have recently accelerated, one would expect DR underperformance to do the same. That is, in fact, what has happened.

We compared the performance of DRs of companies that are listed in London, New York, and Hong Kong, and that are actively traded, with the MSCI Frontier Markets Index which is composed of locally listed Frontier company shares. The group of DRs underperformed the Frontier index sharply over the past year. Going back three years however, there is no particular underperformance. **Foreigners have been aggressive sellers, especially in the past 12 months.** That aligns anecdotally with many confirmed asset outflows from public funds active in Frontier.

	2019 Total Return	3 Year Total Return
Frontier DR basket	3.2%	334%
MSCI Frontier Markets Index (MXFM)	18.0%	150%
performance gap % points	-15%	184%

1350 Avenue of the Americas
2nd Floor
New York, NY 10019
t: 646.738.8078
cgushee@kykloscapital.com

Kyklos Capital

6. The bottom line: Frontier will rebound.

A share can only be sold once (short selling is not available in Frontier markets). With liquidity and valuation below long-term averages, and earnings growth still positive, look for a **return to averages-- "reversion to the mean"-- for volumes, valuations, or both, and outperformance for Frontier equities.**

Charlie Gushee
February 3, 2020

Interesting January Reading

CORONAVIRUS/ economic impact: <http://theconversation.com/what-we-know-suggests-the-economic-impact-of-wuhan-coronavirus-will-be-limited-130598>

What needs to happen for global 5G to work with governments:
https://www.foreignaffairs.com/articles/2019-11-14/real-fight-future-5g?utm_source=dailybrief&utm_medium=email&utm_campaign=DailyBrief2020jan29&utm_term=DailyNewsBrief

What plague of locusts looks like, in Kenya:
https://www.theatlantic.com/photo/2020/01/photos-worst-locust-swarms-decades-hit-east-africa/605653/?te=1&nl=morning-briefing&emc=edit_NN_p_20200129§ion=whatElse&campaign_id=9&instance_id=15542&segment_id=20754&user_id=4baeb6fe754e0153c01a1dcff01508ae®i_id=63336624ion=whatElse

Nigerian brokers are starved for business: <https://www.bloomberg.com/news/articles/2020-01-28/no-one-wants-to-be-a-nigerian-stock-trader-as-volumes-plunge>

One reason corruption doesn't disappear-- US administration may allow US corporations to pay bribes: <https://thehill.com/homenews/administration/478846-kudlow-says-trump-looking-at-reforming-law-on-bribing-foreign>

Kyklos Capital

IMPORTANT DISCLOSURE INFORMATION

This information is intended solely for the addressee, for informational purposes only, is confidential, is not intended for public use or distribution, and may not be reproduced or distributed without the express written consent of Kyklos Capital LLC ("Kyklos Capital") or Charles Gushee.

In addition, the positions discussed in this letter are being provided only for illustrative purposes in order to provide examples of the idea generation, research, and investment process of Charles Gushee. The issuers discussed in this letter do not represent all of the positions selected by Charles Gushee in the Fund. No representation is made as to whether or if the investment ideas represented in the positions discussed in this letter have been or will be profitable. It should not be assumed that Kyklos Capital will be able to identify similar investment opportunities in the future or that any such opportunities will be profitable. The information in this letter is current only as of the date indicated, and may be superseded by subsequent market events or for other reasons. Statements concerning financial market trends are based on current market conditions, which will fluctuate.

This information does not constitute an offering of any security, product, service or fund, including interests in the Fund. An offer or solicitation of an investment in the Fund will only be made pursuant to a confidential private offering memorandum (the "Private Offering Memorandum") and other documents of the Fund (the "Fund Documents") in jurisdictions where permitted by law, and only the information in the Fund Documents should be relied upon when making a decision to invest.

The purchase of interests in the Fund is speculative and suitable only for sophisticated investors for whom an investment in the Fund does not constitute a complete investment program and who fully understand and are willing to assume the risks involved in the Fund's investment program. The Fund will employ certain trading techniques, such as short selling and the use of leverage, which may increase the risk of investment loss. As a result, the Fund's performance may be volatile, and an investor could lose all or a substantial amount of his or her investment. Further, the Fund has substantial limitations on an investor's ability to redeem or transfer its interests, and there is no secondary market for interests in the Fund and none is expected to develop. All of these risks, and other important risks, are described in detail in the Fund's Private Offering Memorandum. Prospective investors are strongly urged to review the Private Offering Memorandum carefully and consult with their own financial, legal and tax advisors **before** investing.

This information is not for distribution in isolation and must be viewed in conjunction with the Fund Documents as it is not intended to be a complete description of the risks of an investment in the Fund or its investment strategies. To the extent there is any inconsistency between this information and any of the Fund Documents, the Fund Documents govern in all respects. Although the information contained herein is believed to be accurate as of the letter date, Kyklos Capital and Charles Gushee do not make any warranty regarding its accuracy or completeness, and will not accept responsibility for any errors in the information, and undertake no obligation to update any information set forth herein. Any projections, market outlooks, or estimates in this document are forward-looking statements based upon certain assumptions, and should not be construed to be indicative of the actual events that will occur. Any information regarding portfolio composition or investment restrictions are intended as examples or guidelines which may be modified or changed by Kyklos Capital at its discretion and without notice to you. Further, as noted in the document, all positions discussed are positions that were held in the Account, which is intended to serve as the development account for the Fund, and such positions do not necessarily represent the positions that will be held by the Fund.