Outlook: Why Active Beats Benchmarks in Frontier Investing-- and Cuts the Risks

"The benchmark of quality I go for is pretty high." **Jimmy Page**

The meaning of "Frontier". The key characteristics of Frontier markets require an active portfolio manager, and for Kyklos, that means that we do not benchmark or choose stocks according to an index. For us, actual Frontier countries are sometimes misclassified by index providers as Emerging. Frontier economies tend to be at an early stage of development, feature lower income levels than Developed countries, and have significant opportunities for expanding infrastructure, education, healthcare, financial inclusion, and funding development. Most Frontier countries offer better trends in demographic and consumption growth, and often improving political governance. Most are subject to significant currency risks. Stocks listed on Frontier stock exchanges often trade at lower levels of liquidity than bigger Emerging-market-listed stocks, and the requirements to open trading accounts and settle trades are often far more complex. As a result, we see very little ownership by foreign index-benchmarked funds in our companies, making our trades far less "crowded," which we see as lowering risks from future foreign selling. Less competition to buy also creates better pricing-- our portfolio's trailing PE ratio is 11.8, over 60% lower than the MSCI World Index (MXWO) and over 30% below the MSCI Emerging Markets Index (MXEF).

The absence of passive investors in our Frontier investment universe is easy to verify. For example, investing in the #1-weighted Emerging index stock, Taiwan Semiconductor Manufacturing Co. (TSM), is straightforward for any fund. Its shares trade in USD on the New York Stock Exchange as well as in Taiwan. Compare that with Pakistan's top index stock, Lucky Cement Co, buying which requires a foreign investor to open an account in Pakistan, provide detailed information on the fund management firm, hire a local accountant, and fund its trading in the local currency, while Pakistan's economy ticks all the boxes for a Frontier profile. While both stocks are in MSCI's Emerging Markets Index, the lists of their foreign shareholders is very different. The biggest passive fund manager, BlackRock, is TSM's #2 shareholder, with a 5% stake, which is over 8 times its stake in Lucky Cement, in which it only ranks as the #15 holder. In Frontier-classified or un-classified countries, passive investors are practically absent. Even the top-weighted company in a popular Frontier-classified market, such as Vingroup in Vietnam, sports only a 0.06% BlackRock stake.

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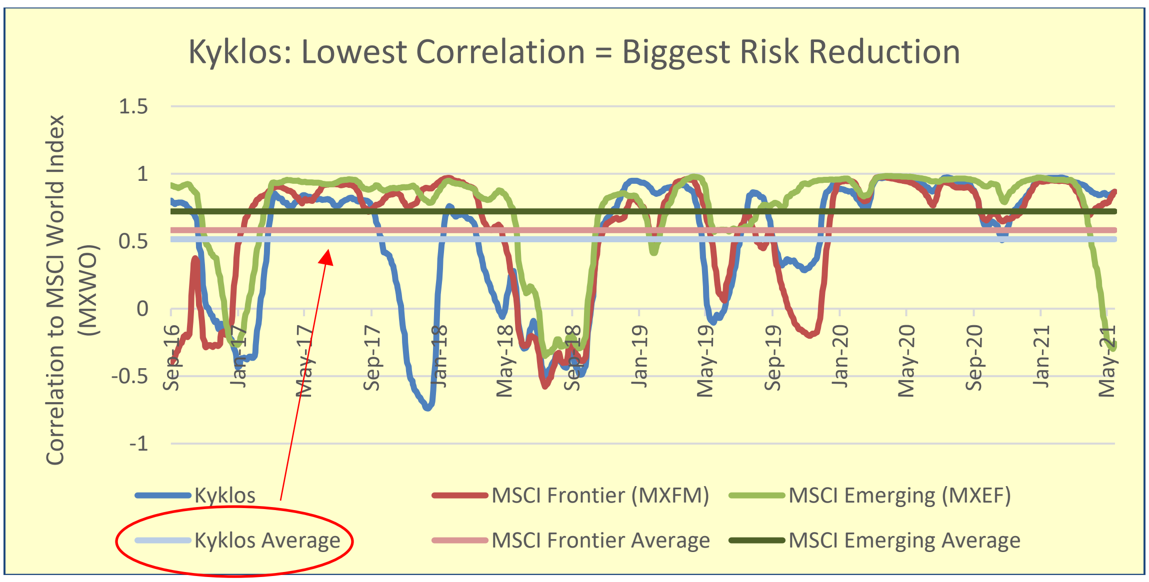
The Payoff. What's the long-term payoff of active investment in Frontier markets, to a typical investor? The answer is lower risk, because of low correlation with the Developed-market investments in their portfolio. A fund with perfect correlation to Developed markets (level of 1.0, in the graph below) would offer the exact same return to a Developed investor, and therefore no reason to diversify into the fund. On the other hand, if there is no correlation with Developed (0.0 below), diversification into the new fund would significantly offset downside risks to the investor. By not benchmarking to any index, an *active* manager such as Kyklos, should offer a lower correlation to the Developed markets than the MSCI Frontier Markets Index or the MSCI Emerging Markets Index that *passive* investors can own via ETF funds—and on average, it does (below). Our average 90-day correlation to the Developed benchmark, the MSCI World Index (MXWO), is close to 0.50 (ie 50%), versus 0.58 for the MSCI Frontier Markets Index, and a whopping 0.72 for the MSCI Emerging Markets Index. For reducing risk, Kyklos offers the best bang for buck to an investor with a Developed markets portfolio.



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