

## **At the Edge of the Earth**

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By Robert J. Rosenberg

On an investment research trip to Kazakhstan in 1998, Adam Weiner decided in the spirit of adventure to take a side trip to Astana, the then–newly renamed and barely known national capital. Astana, as it turned out, was in the middle of nowhere, and airline service was practically nonexistent. Weiner, a London-based emerging-markets trading strategist for Chase Manhattan International at the time, made the journey on a chartered propeller plane. What he found following a particularly bumpy landing, he says, was "a city with beautiful modern buildings, roads and monuments — but almost completely devoid of people," leaving him with a feeling of eerie desolation. "It seemed like a futuristic city on a distant planet."

A decade later, Weiner is managing an emerging-markets strategy for FrontPoint Partners, a \$10 billion Greenwich, Connecticut–based investment firm acquired by Morgan Stanley in 2006. As for Kazakhstan, the former Soviet republic has begun to blossom.

Astana, in fact, is thriving: The capital's population has more than doubled in the past decade, to 600,000, and Astana Finance, a publicly traded financial services powerhouse founded in 1999, serves as the conduit into the area for foreign investors. It is "one of the largest and strongest financial institutions in Kazakhstan," Weiner says.

Once the narrow purview of a handful of far-reaching portfolio managers like Weiner, countries like Kazakhstan, Kuwait, Nigeria and Zambia have drawn broader interest of late among hedge funds whose investments in geographically exotic locales previously were limited largely to the BRIC countries — Brazil, Russia, India and China.

Now as most emerging markets struggle in the wake of the global credit crisis, money is moving to these new frontiers, in particular the markets of the oil-rich Middle East and North Africa (MENA) countries, resource-rich sub-Saharan Africa and the emerging "Stans" of Eurasia: Kazakhstan, Kyrgyzstan, Tajikistan, Turkmenistan and Uzbekistan. Managers say these markets — the once disdained stepsisters to more-attractive emerging markets — offer a measure of alpha that can't be found elsewhere.

Investing in frontier markets is not without risk, of course. Political development is often choppy, and stability is sometimes abruptly interrupted, as evidenced by Georgia, a former member of the Soviet Union whose conflict with Moscow had stewed for years before finally erupting in August, with Russia's retaliatory invasion. Such events can take many — and

often unpredictable — forms: Rebel forces in Nigeria recently attacked oil pipelines and kidnapped foreign workers in the West African nation, and insurgents in Côte d'Ivoire killed security personnel at a gold mining company in that country.

"You have more of an event risk in frontier markets than in developing markets," says Weiner, who joined FrontPoint as managing director and senior portfolio manager in August 2007 after more than a decade at OppenheimerFunds, JPMorgan Chase & Co., ING Barings and PaineWebber International.

"There's no question that these foreign markets remain risky," notes Louis Gerken, founder, chairman and CIO of San Francisco-based Gerken Capital Associates, which manages \$1.5 billion in assets and was an early investor in such emerging markets as China, Hong Kong and Taiwan as well as in several Latin American countries. "But in our view prospects are good over the long term."

Gerken says that one way to mitigate risk, and to maximize returns, in frontier markets is to invest in both public and private securities. "If you know the markets well and the people who you are dealing with — especially if you invest in asset classes like real estate, commodities or nonpublic companies — your chances of succeeding are far greater," he adds. Gerken should know. He has invested in frontier markets since the mid-1970s, when he began his career as an analyst and portfolio manager with London-based GT Capital Management, a pioneer in the sector.

Part of the beauty of frontier markets is that their returns are not correlated with those of emerging markets. In fact, their returns are generally not even correlated with one another. That's important, says Gerken, because it creates the opportunity to find alpha anytime and anywhere. In January, for example, when most emerging markets were down 5 to 20 percent as part of the global equity meltdown, the market in Mongolia was up 5 percent.

Cliff Quisenberry, founder of Investment Frontiers Research, a University Place, Washington-based firm that advises institutional clients on frontier and emerging markets, says that frontier markets have consistently outperformed developed markets. For the five-year period ended July 31, the S&P/IFC frontier market index had an average annualized return of 31.5 percent, compared with 7.6 percent for the Standard & Poor's 500 stock index.

"Until a few years ago, frontier investing in sub-Saharan Africa and Eurasia was the bailiwick of a few dedicated funds," says Quisenberry, who was a portfolio manager at the

Eaton Vance Tax-Managed Emerging Markets Fund from 1994 to 2007. "Now it has very much entered the mainstream."

Frontier investing probably won't appeal to hedge fund managers who like to short stocks or trade frequently. "You can't short these markets," says New York-based Terrence Gray, a lead portfolio manager for DB Advisors, Deutsche Bank's institutional asset manager. "You have to be on the long side, and you can't get out in two days." Like Gerken, Gray invests in both publicly traded companies and private equity deals in frontier markets.

"If you can be a contrarian and patient investor and are willing to make a commitment and invest in the right assets, there's a lot of opportunity," says Harry Krensky, a principal and founder of \$275 million hedge fund firm Atlas Capital Management in White Plains, New York. Krensky, a former Deutsche Bank and Bear Stearns Cos. emerging-markets specialist, was also a co-founder of South Norwalk, Connecticut-based Discovery Capital Management.

Several hedge fund managers cite Nigeria's fast-growing banking sector as a perfect example of a frontier opportunity. Before 2004 the Nigerian banking industry was known for its inefficiency and corruption, but that year the newly appointed governor of the Central Bank of Nigeria, Charles Chukwuma Soludo, began cleaning up the mess. Soludo raised the minimum capital requirements to 25 billion naira (\$195 million) from 2 billion naira, setting off a spate of mergers and buyouts that cut the number of banks in Nigeria from 89 to 25.

Standards rose too, which puts the financial sector on a firmer footing and should enable it to weather political changes better. FrontPoint's Weiner says he likes Nigerian banks because of their momentum and because there's so much room for growth: Deposits have jumped fivefold, to \$56 billion, since 2003, and half of all Nigerians still have never used a bank.

DB Advisors' Gray compares Nigeria's and Zambia's current situations to that of South Korea in 1984 in terms of economic development. "People forget that South Korea was a dictatorship and [the stock exchange] had very little liquidity," he says. In 1984 the average daily trading volume on the Korean Stock Exchange was less than \$10 million; today it exceeds \$5.5 billion.

For Gray the Middle East and North Africa nations and the sub-Saharan region represent the next leg up in the successful expansion of market economies across the globe. "We're at that early stage, where the economy develops, companies come to market and investors

reward those companies as they deliver on their potential," he explains. "Last year five of the ten fastest-growing economies in the world were in Africa."

Gray attributes the growth to several factors: modernization and expansion in manufacturing and service industries, the region's young population and — above all — declining political risk, particularly in North Africa, where there has been widespread turmoil for much of the past decade.

As an example of an African success story, he points to Zambeef Products, a Zambian agricultural enterprise that has grown from modest beginnings as a feedlot business into a producer of poultry, cattle, grain and dairy products. Gray says Zambeef, which is also moving into retail in Zambia and Nigeria through a broad line of products (including Zamchick, Zammilk, Zamleather and Zamflour), has great potential; for the past few years, earnings have grown by 25 to 30 percent annually.

Despite the obvious appeal of the Middle East and North Africa from a pure investment perspective, the regions are underowned and underresearched, says Gray. His team at DB Advisors is spending much of its time lately on such countries as Kuwait, Nigeria, Qatar and Zambia, which have benefited from the huge spike in oil prices during the past 12 months.

"While people's opinions may fluctuate as to whether the price of oil is going to be \$150 or \$125 a barrel, most of these countries have the price of oil projected at \$60 or \$75 in their budgets," says Gray. "And so they're just printing money."

The high price of oil is freeing up MENA countries to invest more heavily than ever in diversifying their economies. In fact, some of the world's biggest development projects are under way in the region, notes Bruce Fenton, managing director of Norwell, Massachusetts-based Atlantic Financial, an asset management company that specializes in emerging markets. Fenton's U.S.-Arab Gateway Fund (Atlantic is the investment manager and general partner), a hedge fund that invests in MENA, has had an average annual return of 24 percent over the past eight years. It invests in large, fast-growing, highly liquid public companies with low price-earnings ratios like Emaar Properties, a Dubai-based real estate and construction company, and conglomerate Saudi Basic Industries Corp. in Riyadh, which produces plastics, fertilizers and steel.

"There's a huge disconnect between the size of the opportunity and the investor awareness and understanding of the MENA region," says Fenton, who founded Atlantic Financial in 1994.

Sub-Saharan Africa, like MENA, is benefiting from steeper oil and commodities prices. Although high inflation rates have historically gone hand in hand with high growth rates in the region, inflation is easing as central bankers mend their tendency to print money willy-nilly at the behest of governments.

The International Monetary Fund predicts that sub-Saharan African economic growth will reach 6.75 percent this year, up from 6 percent in 2007, and that inflation will drop to 6.75 percent, down from 7.5 percent in 2007. The combination of increasing growth and falling inflation is helping draw foreign capital, which totaled \$53 billion in 2007, according to the IMF.

Some managers say the best sub-Saharan opportunities are in fixed income and currency bonds, which typically involve a bet that a particular currency will appreciate and that its government can keep its fiscal house in order. FrontPoint's Weiner likes Zambian local currency bonds, which yield 11 percent. The Zambian currency, the kwacha, has appreciated steadily alongside copper prices since early 2007; copper and cobalt represent 64 percent of the nation's exports.

Weiner points to Côte d'Ivoire's distressed debt as another promising investment. The country has dollar- and euro-denominated debt on which the government has defaulted and which it is in the process of restructuring. "Over the next nine to 12 months, that story will play out as far as determining the right amount of debt forgiveness," explains Weiner. "It's a fairly complicated analysis, but it's a good way for hedge funds to deliver alpha."

Other Treasury bond opportunities, says Weiner, include those in Angola, Cameroon, the Republic of Congo, Ghana and Uganda. "A lot of them are petrol plays," he explains. In addition to his investments in Africa, Weiner is putting money in a place most investors would think twice about: Iraqi government bonds. "We're bullish on Iraq," he says, noting that oil production is back up to prewar levels of 2.5 million barrels per day and that the Iraqi government is building up reserves thanks to high crude prices. Even in the event of a possible breakup of Iraq, he adds, the bonds should continue to pay: "It sounds a little contrarian, but as a fixed-income play, it's a good investment."

Two years ago, Susan Payne and her colleagues at Emergent Asset Management, a Surrey-based hedge fund firm, hatched a plan to launch a fund to invest in farmland in sub-Saharan Africa. Partnering with Pretoria, South Africa-based Grainvest Futures, a group of agricultural engineers and traders, EAM is launching the \$250 million Africa Land Fund this month. The fund is buying up farmland to grow biofuel and industrial crops like corn and soybeans as well as timber and other food crops (the biofuel and industrial crops will be

grown in sandy soil to avoid taking more-arable land from other farmers). As sub-Saharan farming becomes increasingly modern, EAM expects crop yields to rise significantly and the value of farmland to appreciate.

"These lands currently are one seventh the value of Argentinean or U.S. farmlands," notes Payne, who founded EAM in 1997 and is its chief executive officer. "So the returns of the fund will be through capital gains and also through returns delivered on crop yields. We are securitizing the land and returning an annual coupon to our investors on that land."

Payne — a lawyer by training who began her investment career in 1986 at J.P. Morgan & Co. in London, where she was head of emerging-markets sales for Europe — thinks the region will one day be one of the world's major breadbaskets. "Because of its series of microclimates, its highlands, its agricultural diversity and good logistics, South Africa and sub-Saharan Africa can deliver an enormous amount of food," she says, predicting that initial big investors in her fund will include sovereign wealth funds, university endowments, pensions, funds of funds and wealthy individuals. "Food security will be one of the driving themes over the next few decades."

EAM's African Land Fund, which Payne believes is capable of returning 30 percent annually, offers a unique combination of social responsibility and environmental sustainability in a neatly fashionable package. Aside from limiting its use of arable land, the fund plans to set aside some profits for school construction and programs that provide local residents with computers. "When you can make the returns that we are projecting and still wrap a socially responsible investing element in, then you've hit a home run," Payne says.

Taking a completely different approach, Greylock Capital, a \$600 million New York-based hedge fund firm, is launching the Africa Opportunity Fund, a banklike venture that will provide long-term financing to promising companies in Cameroon, Ghana, Nigeria, Tanzania and Uganda. The fund will provide the kind of two-, three- and five-year loans that can be hard to come by in Africa. Investors will get an equity kicker, says Greylock Capital chief executive officer and president Hans Humes, who will manage the portfolio and says the plan should be attractive to borrowers and investors alike. "We're coming in on the ground and allowing companies that in the past would have to plan from quarter to quarter to think in terms of a five-year plan," Humes notes. "And if it works and growth takes off, as we expect it will, then we're asking them to give us a piece of the upside."

The idea is to find companies that are below the radar, and Humes should be able to do so, given his background as an active investor in Africa for more than a decade at Madrid-based Banco Santander. Greylock would like to raise \$200 million to \$300 million and is looking

to do about 30 deals of \$2 million to \$10 million apiece. Humes, who hopes to deliver annual returns of 25 to 35 percent, says the greatest challenge lies in educating potential borrowers about the advantages of making long-range plans rather than working from quarter to quarter.

Part of Greylock's strategy is to leverage the deals by tapping U.S. government lending recently earmarked by President George W. Bush's administration to bolster investment in Africa through the Overseas Private Investment Corp., a U.S. agency established in 1971 to help American businesses invest abroad and to foster development in new and emerging markets. Humes says that move will prove immensely helpful to efforts like his.

Noting likenesses between Africa and such Latin American countries as Colombia, the Dominican Republic and Peru, which still lack well-developed commercial banking sectors, Humes says Greylock is planning a similar fund for that region. "We're providing something that's off the beaten track," he says. "Identifying the people, identifying the projects — we've done that. Executing the deals is the tough thing."

Eurasia is alluring, too, with its appeal most evident in a handful of former Soviet republics. Some managers say the best way to play that frontier is not through commodities, sovereign debt or currencies but by betting on publicly traded securities.

"Kazakhstan has been a big focus for us," says FrontPoint's Weiner, a fan of Astana Finance. Although its profits were up 25.9 percent in 2007, the bank's share price has been under stress of late, dragged down by the same sector that has been hampering the U.S. economy: real estate.

Kazakhstan's rich mining sector has also attracted foreign investment, particularly in Eurasian Natural Resource Corp., the world's biggest producer of ferrochrome, an essential component in steel production. The company also supplies 40 percent of the world's gallium, a key material in the manufacture of some semiconductors. Shares of ENRC soared after it began trading on the London Stock Exchange in December 2007, and by late summer the stock price was up more than 100 percent since its IPO.

Alisher Djumanov, a managing partner of Eurasia Capital Management, a subsidiary of Singapore-based Eurasia Capital Group, says London-based ENRC may merge with Kazakhmys, the biggest copper miner in Eurasia and the tenth-biggest in the world, also based in London. "The Kazakh government is encouraging the consolidation," says Djumanov, whose firm's offices are in Almaty, Kazakhstan. "But whether or not this

consolidation takes place, there is a bullish outlook for acquisitions abroad in resource-rich places like Mongolia."

Indeed, Djumanov sees value in a Mongolia mining project heavily backed by Vancouver, British Columbia–based Ivanhoe Mines. Ivanhoe's core assets include its Oyu Tolgoi copper and gold mine holdings in southern Mongolia and its stakes in Mongolian coal miner SouthGobi Energy Resources.

With frontier promise comes peril, however, a point well illustrated in recent weeks in Georgia. That country's financial sector is reeling after the Russian invasion: Fitch Ratings swiftly downgraded the country's major banks, including Tbilisi-based Bank of Georgia, to "negative" from "stable." Still, Djumanov has been impressed by that bank's efforts in recent years to bring in a team of foreign professionals to help introduce Western-style management and transparency. Bank of Georgia has been a key player in attracting hundreds of millions of dollars in foreign investment.

Although the political climate in sub-Saharan Africa and the Middle East is calmer than it has been, tensions lurk beneath the surface and around the edges. Kazakhstan is not that far north of Afghanistan and Pakistan; Zambia borders troublesome Zimbabwe; Iraq is a gamble by any stretch.

Therein lies a fundamentally vexing issue for investors: In addition to the usual market corrections that accompany any hot new market, frontiers are especially vulnerable to political upheaval. Analyzing that possibility — in addition to understanding the particular market risks — requires a unique and uncommon skill set.

So it's no surprise that DB Advisors' Gray says frontier markets remain underappreciated by most foreign investors, though he expects that to change, probably sooner rather than later.

"We've been investing in these countries for ten years," he says. "We know the companies. We've seen the changes. We've seen the ups and the downs. These companies are well positioned, and we're waiting for other investors to discover the opportunities."