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UPDATE – FRONTIER MARKETS EQUITY STRATEGY

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We often remind our clients that Frontier markets are less correlated to the global business cycle and to each other, hence the asset class actually tends to exhibit low volatility. However, the double impact of oil and COVID-19 has unfortunately not bypassed Frontier and, like most asset classes, the first quarter has been painful. The MSCI Frontier Markets index ended the quarter down 26.4%, so behind the MSCI Global Emerging Markets index on -23.6%.

Oil exposure

Looking through the frontier universe, we have a few large oil exporters (Kuwait, Kazakhstan, Nigeria), balanced by a longer tail of oil importers (Vietnam, Bangladesh Sri Lanka, Morocco, Romania, Kenya). The asset class actually has a very low weighting to energy (2.8%[1]), so the key influence of oil on the asset class is through the economic impact on the oil exporting countries rather than oil stocks themselves.

For these oil-exposed economies, we have to consider their overall financial health and for how long budgets and balance of payments can withstand lower oil prices, and in turn whether that will lead to excessive currency pressure. The reality is that at the current level of oil prices, some economies will be in real trouble.

Take Nigeria for example, where growth and fiscal and debt dynamics are deteriorating fairly rapidly - especially challenging for a country with a young and growing population. The managed exchange rate is an impediment to releasing the pressure, and we have seen the re-emergence of a black market currency rate with a widening spread. The three-month NDF (non-deliverable forward) implied yields are pricing in a 10% devaluation in Nigeria, but if oil is to average US$40 a barrel (or lower) for an extended period it will have to move more than this. Capital controls could also be on the table. At this point, therefore, our portfolio is no longer holding any positions in Nigeria.

We think Kuwait will fare relatively better in terms of its resilience to a lower oil price (it has one of the lowest fiscal break-even levels amongst the Gulf countries), but we have also shifted from a small overweight to an underweight position, having started that move anyway after strong performance in late 2019. The Gulf markets have been more resilient than some might expect, with our traders seeing signs of state support for the markets in recent sessions.

COVID-19 and Frontier Markets

Our analysts around the globe have been doing a fantastic job at pulling together all the data points to track the virus impact, including in Frontier markets where the impact is less straightforward and less well reported. The caveat to looking at the figures is that testing rates are generally very low. Romania is currently showing one of the worst mortality rates (3.5%), while infections seem to be at earlier stages in Africa. Vietnam is currently reporting zero fatalities, and has also locked the borders. Many of the frontier countries are in lockdown, or have key urban areas in lockdown, and in general they have done this earlier in the corona journey than developed markets. We are watching closely given that, for Frontier (along with many other emerging markets), the social

[1]Energy sector weighting was 2.78 % of the MSCI Frontier Markets index at the end of March 2020

set-up and reliance on informal workforce may not be able to tolerate long periods of economic shutdown. Populations are younger, which should be helpful, but healthcare systems are typically less well developed.

GDP exposure to tourism can be high in some of our countries – the impact will be tough on Sri Lanka for example, which should have been benefitting from a nice tourism recovery after a difficult 2019.

As in many other global markets, it is very difficult at this stage to have accurate forecasts for the depth of economic hits and the adjustment to earnings that need to be made for 2020. In our view, Frontier markets had very attractive valuations coming into this year, and on the face of it, even more so after the recent market moves. But current earnings forecasts are not a solid denominator. What we can continue to focus on is the long-term fundamentals of our individual companies, their positioning and balance sheet strength to withstand these difficult times. We have taken the opportunity to move out of some positions where there may be more of a business impact over the long term, and lean in to the highest quality. Leverage across most of our companies is low.

When we look at our attribution for the quarter, our large position in Vietnam has unfortunately acted as a drag. The market had been behaving in line until the last week of March, when it fell as other markets rose, hurting our relative performance. Having thought they had escaped the worst of the virus, Vietnam announced a lockdown (as with some other countries in Asia who are protecting against a second wave). We are maintaining our position for the time being. We think the macro backdrop in Vietnam remains very solid, and our holdings are in high quality companies, many of which are at foreign ownership limits. Vietnam did move quickly in the early stages of the virus to close borders with China, and indications are that things are mainly under control.

On the positive side, our ability to engage with companies has been excellent – the team have spoken to the vast majority of portfolio companies just in the last few weeks. Markets in general have stayed open – the Kuwait exchange has remained open despite a two week ‘bank holiday’ and lockdown (Sri Lanka is the exception having closed while Colombo district is under curfew) and our trading experience has remained good.

The following risks are materially relevant to the portfolio:

Currency risk - changes in currency exchange rates could reduce investment gains or increase investment losses.

Emerging markets risk - emerging markets are less established than developed markets and therefore involve higher risks.

Frontier markets risk - small market nations that are at an earlier stage of economic and political development relative to more mature emerging markets typically have limited investability and liquidity.

Sector concentration risk - the performance of a portfolio that invests a large portion of its assets in a particular economic sector (or, for bond portfolios, a particular market segment), will be more strongly affected by events affecting that sector or segment of the fixed income market.

Small and midcap risk - stocks of small and mid-size companies can be more volatile than stocks of larger companies.

General Portfolio Risks

Capital risk - the value of your investment will vary and is not guaranteed. It will be affected by changes in the exchange rate between the base currency of the portfolio and the currency in which you subscribed, if different.

Counterparty risk - an entity with which the portfolio transacts may not meet its obligations to the portfolio.

Geographic concentration risk - to the extent that a portfolio invests a large portion of its assets in a particular geographic area, its performance will be more strongly affected by events within that area.

Hedging risk - a portfolio's attempts to reduce or eliminate certain risks through hedging may not work as intended.

Investment portfolio risk - investing in portfolios involves certain risks an investor would not face if investing in markets directly.

Management risk - the investment manager or its designees may at times find their obligations to a portfolio to be in conflict with their obligations to other investment portfolios they manage (although in such cases, all portfolios will be dealt with equitably).

Operational risk - operational failures could lead to disruptions of portfolio operations or financial losses.

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