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INVESTING IN FRONTIER MARKETS

THE ONLINE REPORT WHERE PENSION SCHEMES, SOVEREIGN WEALTH FUNDS AND PRIVATE BANKS EXAMINE THE THEMATIC AND PRACTICAL ISSUES SURROUNDING FRONTIER MARKET INVESTMENT AND THE GROWING POTENTIAL AND OPPORTUNITIES THEREIN.

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RAMON TOL
Pension Fund Manager
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SEIZING OPPORTUNITIES IN FRONTIER MARKETS

SPECIAL GUEST INTERVIEW

AFRICA'S POTENTIAL FOR ECONOMIC GROWTH AND INVESTMENT IN THE COMING DECADE

INTERVIEWER:

HUBERT DANSO
Vice Chairman and Chief Executive Officer
Africa investor Group

INTERVIEWEE:

PROFESSOR (MTHULI) NCUBE
Chief Economist and Vice President
African Development Bank Group

HUBERT DANSO: I'm glad that we have another opportunity to speak about something that is close to both of our hearts and day jobs - Africa's potential for growth. Just as a brief introduction, we all recognise that there is an increasing appetite to invest in Africa, driven by its status as one of the world's fastest growing regions and its rich natural resources. We're seeing more demographic trends such as increasing urbanisation, the rise of the middle classes, improved research on the emerging markets and an increased interest from the international investment community. This lends itself to the long term investment case for Africa to the point where now we've seen foreign direct investment up by 80% as an average over the last 10 years, and our forecast is that FDI into Africa is likely to reach 150 billion by 2015. Based on this, I'd like to ask you: what do you see as the macro economic climate from a forecast perspective for sub-Saharan Africa in the coming decade? Also, in your opinion, what kind of growth and investment opportunities for foreign investors will we see over the long term?

> ***"The opportunities for investment going forward are numerous."***

PROFESSOR (MTHULI) NCUBE : Thanks very much Hubert. The economy does go through ups and downs but generally our prognosis for Africa over the next decade is very positive for many reasons. First of all, from just an external point of view, if you look at how Africa has performed during and after the crisis, the performance and rebound has been commendable and we are encouraged by this. Economic management across more economies is also encouraging, and mid-management in many African countries is maturing to a point where we can see the building blocks of financial shock absorbers being implemented for any future crisis. We are also encouraged by the desire and steady progress to diversify in almost every economy in Africa including those with substantial natural resource endowment who are aspiring to develop their agricultural sectors where 60%-70% of the population is typically employed. All of these are encouraging signs in regional Africa. The rate of growth of the middle class is also quite encouraging particularly because the segment of the middle class at the lower end of the spectrum has typically been quite vulnerable to shocks but is now experiencing high levels of growth. Because of this stronger middle class, domestic growth is driving a good part of the demand that we see for consumer goods in Africa. In addition, the positive political changes that we are seeing in Africa are testament to the fact that people are accepting that democracy is important, that institutions are important, and that all of this is helping create the right type of environment for investments. The macro-economic climate is looking positive and certainly the opportunities for investment going forward are numerous, whether in the equity market which is slowly but surely developing, or in the several income markets, which are growing albeit slowly because corporations are not issuing bonds quick enough- but this is a very positive sign. Also you see the potential in the private equity front with investment coming in not just for natural resources but for opportunities in the regional sectors, in the banking sector and infrastructure.

> ***"The solidification of a stronger middle class has put many African countries firmly on the list of frontier market economies."***

HUBERT: Fantastic. It's always great to see the positive manifestation of good economic policies beginning to deliver the desired impact and

to implement the intended shock absorber components that are critical when living and working in such a fragile economic system. African economic growth and the solidification of a stronger middle class has put many African countries firmly on the list of frontier market economies and I want to ask you, what specific factors are driving Africa's growth in terms of frontier markets such as Botswana, Kenya, Mauritius, Nigeria, Ghana, and Namibia, and do you think this growth is sustainable?

> ***Economic diversification is working positively for some African countries.***

PROFESSOR NCUBE: There are many factors driving Africa's growing dynamism. Firstly, it is the general positive political environment or what we would call democratisation. Secondly, it is really the rate of growth of the domestic market which show the rate of growth of the middle class. This class has been growing at something like 3.2% per annum since the early 1980s. This is a higher rate of growth than the overall population growth so it is definitely something positive here about the extent of growth of the domestic market, which is the demand the consumer is willing to pay for goods and all manner of services that are offered in Africa. The other driver is regional integration. If you look at the movement of people, it is more than the movement of goods and services frankly. Another factor within the integration area is intra-African investment, that is, African countries investing in other African countries. We see this with the banks and other companies, so that is a big driver of internal regional integration. In my view, Africa, and specifically Kenya, has been leading the way in terms of technology in the whole space of financial inclusion. Through the banks of Kenya and others, we have managed to create enormous inclusion of people and in our view it's helping push credit where credit is required and getting people to begin to use the formal banking system. Integrating people into the modern economy is very important for increasing the size of the market. Another factor has been economic diversification. Of course, Nigeria is an oil producing country but the servicing sector and the agricultural sector are creeping up and beginning to challenge the oil sector which is very positive, so economic diversification is working positively for some African countries. There has also been some investment, albeit slow, in the area of infrastructure, particularly in the areas of roads, railway lines, power lines, etc. We know that it will take a lot of money to close that gap, upwards of $1 billion of investment per year, but progress is being made. These are just some of the ways that Africa is making progress among many other reasons.

HUBERT: Clearly there is a lot happening and, as we see, the world is starting to become more aware of some of these impactful projects, investments and trends that you just mentioned. A question remains, however, that there has historically been a negative perception of the continent from the investment and development finance standpoint. Do you find that there is a gap between perception and reality when foreign investors consider investing in sub-Saharan Africa? If so, why? And is there a clear role for the African Development Bank to be doing something about this? I know that you are doing a lot so I welcome your views.

PROFESSOR NCUBE: There is certainly a gap between the reality of Africa's potential for investment and the perception. If you tell many people that some of the highest investment returns in the world are made through investing in Africa, they often don't believe you. So there is certainly a gap between perception and reality. This can be explained by what I call risk pooling. If something happens in one country or region, it is assumed to be happening all over Africa, which is not correct. Foreign investors need to begin to differentiate between the different countries and regions. Also, there is a lot that needs to be done by the countries themselves. Advertisements on CNN and other media marketing specific countries from a tourism perspective are a great example of this, and that is a strategy that can be used for countries to differentiate themselves, differentiate their regions and project the unique characteristics of their country to investors. The African Development Bank needs to do a lot more and our mandate is to champion every region and every country and we hope that by doing so, it will contribute to lifting and improving the image of the entire African continent.

HUBERT: That is a very interesting point. We hear from a number of investors that they unashamedly add in about 40% to a project cost for some of the major projects to account for perceived as opposed to actual risks. So there is something that an institution like yours can do to sort of play the arbiter role. A lot of the investors then turn around and rightfully explain that it's really about the policies on the ground. How are those being contextualized so that there is a hospitable and

> ***There is certainly a gap between perception and reality.***

predictable operating policy? From your perspective, what impact will the African Development Bank's innitiatives have on encouraging foreign investment into Africa's frontier markets?

PROFESSOR NCUBE: Well, it's very important for the African Development Bank and other institutions to 'invest in investing'. This really means that we should invest in improving the environment in these countries so that people and investors can feel more confident about the quality of institutions, transparency, protection of their investments and so forth. This is one big pillar. So the investment really tries to deal with the local economy in a big way to improve the protection of investments in specific countries. Perhaps we could also publicise which countries are taking on what specific programs for improving the investment trend so that investors could be aware of which country is making the efforts to improve the investment plan. Often just announcing that can trigger investors to say, 'Hey this country is serious- I'll take a look at the opportunities and see whether I can invest.' So there is a bit of marketing that can be implemented in an effort to appeal to investors. The ADB has a new initiative which aims to look at different capital markets as well as support financial institutions that make it happen. If you look at what I mentioned earlier about the weak bond market across Africa, we are looking at launching an African bond index. This is a way of not just shining a torch on the bond market, but creating a benchmark for anyone investing in the sector. A lot of work has been done on the equity market, which is coming along nicely, but there is very little on the bond market.

"We haven't seen a lot of action with pension funds in countries other than South Africa."

HUBERT: As you know, we are starting to see a rise in African pension funds which are very well endowed. Is the African Development Bank engaging the pension funds sector within Africa to invest more domestically as well as create an environment for more cross-border investing?

PROFESSOR NCUBE: The African Development Bank is partnering some of the pension funds in South Africa with other African investment opportunities. Of course, we haven't seen a lot of action with different pension funds in other countries other than South Africa, but there is some activity. I think a lot has to do with the entrepreneurial initiatives in these countries because one of the best ways to partner a pension fund is to have entrepreneurial ground in specific countries encouraging the pension funds to come in, partner and invest in these projects.

HUBERT: Superb. Well I think that's really all the questions that we have today and I want to thank you for your answers. You've really shed a lot of light on these important issues and gone into the right level of detail and I feel that a lot of the investors, particularly the international institutions, will benefit from this. We actually feel that we are moving to a new era now, obviously not just because of the state of the global economy, but through economic and international investment profile it takes us back to the days of the General Agreement on Tariffs and Trade (GATT) moving into the World Trade Organisation where the big phrase was "trade to invest and invest to trade". I think you've coined the phrase that a lot of the institutions within and outside the continent can really align with and that is "invest in investing". That's the opportunity.

"We are moving to a new era now."

WHITE PAPER

A Perspective on Asset Allocation to Smaller Emerging & Frontier Markets

KEMAL AHMED
Portfolio Manager of the Emerging & Frontier Markets Equity Strategy
Investec Asset Management

Much has been written about the role of investable African markets in the context of allocations to global emerging and frontier markets. This is particularly relevant in a world where the so called emerging and frontier markets are evolving into an economic power likely to rival developed markets during this century.

The focus of this article is not on the investment attributes of African markets, per se; rather it seeks to provide a conceptual framework to making global investment allocations to smaller emerging and frontier markets that include Africa.

Investors in emerging and frontier markets equities generally, and African public equities in particular, are seeking exposure to a package of real GDP growth, potential currency appreciation over the long term and reflationary, rather than deflationary pressures on prices. An economic case can be built using many different factors, but we believe that the following five are critical toward understanding the economic potential of particularly the smaller emerging and frontier markets. These markets typically lie beyond the mainstream investment horizon of most investors.

While these factors hold for the asset class in general, we find that they are particularly relevant for the smaller emerging and frontier markets.

- **The WTO impact:** Emerging and frontier markets are undergoing a profound shift in the way in which their economies are evolving. Economic liberalization, a structural outcome of membership in the World Trade Organization, is irreversible and has produced significant investment opportunities – both in the public and private markets. We believe that the impact of the WTO is one of the least understood macro catalysts for long-term asset allocations.

- **Healthier balance sheets:** Increasingly, the relative and absolute health of emerging and frontier markets sovereign and corporate balance sheets (to advanced economies) have provided favourable support for continued strong GDP growth and hence, a favourable investment climate.

- **Demographics:** The emerging and frontier markets make up more than 70.0% of the world's population and even more of the world's young population. Emerging and frontier markets generally have a growing labour force and falling dependency ratios (the ratio of working population to dependents). We believe that the story of capital flows over the next generation will essentially be predicated on the movement of savings from the aging populations of the advanced economies to the younger and growing populations of the emerging and frontier markets. China's and India's population sizes are well understood but the rest of developing Asia and Africa over the next two decades show a rapid increase in working population. The demographic trends in the emerging and frontier markets offer increased opportunities for productive investment through the rise of domestic demand, driven by the needs of a younger population growing both in size and in wealth, as it acquires more and more of the trappings of modern urban life.

- **Urbanisation and the emergence of domestic demand:** GDP growth in the emerging and frontier markets is being driven to a significant extent by the growth of middle income consumers and a major stimulus to this has been urbanization with its accompanying needs. Urbanization and the growth of the middle classes go hand in hand. Asian countries within the smaller emerging and frontier markets universe such as Indonesia, Malaysia, Thailand and Vietnam are poised to become predominantly middle-class countries within 10 to 15 years. The middle classes can afford at least the basic trappings of modern urban life in the form of refrigerators, mobile phones, motorcycles, and cars to name a few examples. Such consumption can be further boosted through a few key initiatives within an emerging or frontier market: establishing minimum provisions for old age removes the necessity to save as much as possible to ensure an income post retirement; establishing the use of credit facilitates the purchase of high value goods with the costs spread over lifetimes; and developing a retail infrastructure to package and transport goods across a country enables goods to reach the consumers. Local companies are often best equipped to service the demands of the lower income consumer groups and by so doing they develop their own brands and domestic client base, which become increasingly valuable as the economies and their clients increase in wealth.

The urbanization phenomenon that is taking place within the emerging and frontier markets is providing massive impetus to both the development of the middle classes and the subsequent boost to GDP growth. Urban life requires considerable investment in infrastructure to support the population. The lifestyles of urban dwellers generates economic activity across a huge range of areas ranging from private education to transportation, retail outlets, entertainment, healthcare to name but a few of the industries that typically emerge. This environment creates a situation in which local businesses can develop and grow into national champions, often providing the local expertise and partners that international.

- **GDP growth, of course:** The economic case for investing in emerging and frontier markets, particularly Africa, is ultimately predicated on the fact that these markets are likely to experience higher GDP growth than the developed markets. We believe that smaller emerging and frontier markets will be a key driver of global GDP growth in the future. We do not infer from this that because these markets will experience higher GDP growth they will concomitantly experience higher equity markets returns; rather that the emergence of domestic demand (a "consumption economy") underpinned by higher GDP growth and rising income levels is resulting in a rich, relatively undiscovered, set of investment opportunities.

As economic opportunity migrates, emerging and frontier markets are moving from an opportunistic allocation to a core component of an institutional investment plan. The emerging and frontier markets' share of global GDP (in USD terms) is already 35.2% and on a purchasing power parity basis is almost 50.0%.[1] There is growing recognition on the part of investors that exposure to the emerging and frontier markets must increase and it is likely that allocations will increase by substantial amounts in the coming years. However, it will also be important to ensure that investors have exposure to a much wider opportunity set than is currently available from the traditional, industry standard, investment universes for the emerging and frontier markets[2].

The traditional approach rests on the adoption of a framework based on capitalization weighted indices. But whilst their use as performance benchmarks for active strategies has a strong logical appeal, it frequently distorts investment decisions in a profound and detrimental way. Capitalization weighting is inflexible in terms of expressing forward looking views and the index security selection rules do not capture the complete opportunity set. This incomplete opportunity set often leads to unnecessary volatility in allocations. Moreover, index providers have each developed their own pragmatic but unique approaches to classification, giving rise to significant differences between the indices. In our experience the flow of investment capital tends to be heavily skewed toward the large emerging markets (i.e., seven countries including the BRICs). These seven large emerging markets[3] account for approximately 80.0% of the MSCI EM. The remaining 14 countries in the MSCI EM – smaller emerging markets[4] – receive little dedicated investment in most traditional asset allocation exercises (Egypt and Morocco are the only African countries to form part of this subset).

Most asset allocators have historically invested in emerging markets via actively managed global emerging markets funds that are benchmarked to the traditional emerging markets indices. However, of the 824 stocks in the MSCI EM 604 stocks (approximately 73.0% of the index) are drawn from the BRICs[5], Korea, Taiwan and South Africa. Allocations to frontier markets (and Africa!) tend to be made out of the marginal dollar, and are even less than allocations to smaller emerging markets. When it comes to the more recent interest in frontier markets, the problems become even more acute. Dominant indices such as the MSCI Frontier Markets index and the BMI S&P Frontier Markets index have even more concentration than the traditional emerging markets indices. Diversifying exposure by investing in an actively managed frontier markets fund, benchmarked to the MSCI Frontier Markets index, will mainly result in exposure to five Frontier Markets (of which Nigeria would be the only African candidate) which account for approximately 62.0% of the FM benchmark. As a result, investors expecting diversification and risk reduction through an allocation to a frontier markets indexed investment run the risk of experiencing a lack of expected diversification with increased volatility.

In other words, market-capitalization based approaches inevitably limit the universe available to investors, concentrate exposure in a handful of countries (whether in the MSCI EM or the MSCI FM) and fail to deliver on either diversification or consistent long-term capital appreciation. We contend that an entire investable universe of markets beyond the immediate investment horizon - smaller emerging and frontier markets - exists that are under-represented, often poorly understood or inadequately researched and in many cases excluded from investment. The stock markets of Africa are a prime example of such a universe.

The optimal approach for investors seeking to build out thoughtful exposure to Africa specifically, and the smaller emerging and frontier markets that lie on the investment horizon beyond mainstream emerging markets would be to recast the traditional index framework and embrace a fresh perspective on allocation. Simply increasing existing exposure to mainstream emerging markets via an indexed approach represents, in our view, a sub-optimal outcome.

We believe that exposure to the emerging and frontier markets should include a strategy that also accesses the broader opportunity set in smaller emerging and frontier markets. In particular, we believe global investors should consider incremental allocations to benchmark agnostic investment strategies focused on these markets that have a strong emphasis on local perspective.

In our view, because these markets present inefficiencies, asset managers with local networks and proven track records arguably possess a significant edge. Such managers also access a broader investment universe and complement existing allocations to the large emerging markets.

1 Based on IMF World Economic Outlook 2011.
2 We refer to the MSCI Emerging Markets index ("MSCI EM" or the "EM benchmark"), the S&P/IFCI and the FTSE Emerging Markets as the traditional emerging markets indices. Similarly, we refer to the MSCI Frontier Market Index ("MSCI FM" or the "FM Benchmark") and the S&P Frontier Broad Markets index as the traditional frontier markets indices. For the purposes of this paper the MSCI Emerging Markets and the MSCI Frontier Markets indices are used as proxies when discussing allocations by investors. Even if one were to conduct our analysis relative to the other dominant index providers, S&P or FTSE, the conclusions of our analysis are remarkably similar.
3 We define large emerging markets or LEMs as countries that are greater than a 5.0% weight in the MSCI EM.
4 We define smaller emerging markets or SEMs as countries that are less than a 5.0% weight in the MSCI EM.
5 Brazil, Russia, India and China were coined the "BRIC" economies by Goldman Sachs chief economist Jim O'Neill in 2001.

INTERVIEW

Beyond the BRIC; Identifying the Next Investment Opportunities & the Vehicles that are Best Suited to Capitalise on Them

INTERVIEWER:

NOEL HILLMANN
Managing Director
Clear Path Analysis

INTERVIEWEE:

TONY CHARLWOOD
Investment Officer
The Pensions Trust

NOEL HILLMANN: **In terms of 'the next 11', the world's largest economies after the BRICs in the 21st century, where do you see the most promising opportunities for institutional investors and what investment vehicles are best suited to capitalise on these opportunities?**

TONY CHARLWOOD: The mix of the countries is very interesting. South Africa and South Korea are already large and the FTSE index compilers already designate Korea to be a developed market. Others never seem to lift off highlighting the problem for institutional investors as many frontier markets in small economies have small companies, so even if there is a vibrant stock market the opportunity is very limited. Of the 11 countries mentioned in your list, 5, Indonesia, Mexico, Philippines, Korea and Turkey are already significant constituents of the emerging market indexes and have liquid stock markets. Bangladesh, Egypt, Iran, Nigeria, Pakistan and Vietnam are true frontier markets, with stock markets at different stages of development and offering different degrees of liquidity. The opportunity is limited by the ability to invest and that is before fundamental factors have been considered. As for the right investment vehicle, all but the largest institutions are unlikely to have the in-house capabilities to invest in frontier markets directly and so will have to turn to a specialist investment manager who will either run a segregated portfolio or use a pool fund depending on the size of the mandate. Either way, the investment will probably be part of the global equities allocation so we are talking about requiring the liquidity of an open ended fund which could well be a challenge to the manager in certain market conditions such as those experienced recently.

NOEL: **When considering the likes of Bangladesh, Egypt and Mexico as institutional investors, does that pose an opportunity because they are such a low lying basis, or does that wipe them off the mat for the time being as invest-able areas?**

TONY: It creates opportunities as long as you are diversifying your risk. These are markets where there are always external risks and shocks which the stock markets are susceptible to and that has to be taken on board as par for the course. If it has the effect of beating down stock market values to very low and attractive levels then that should be seen as an opportunity for institutional investors who have long timehorizons

NOEL: **What type of investment managers do you feel are most suitable for economies such as private equities, the equity market and infrastructure and what are the most suitable structures to be utilizing?**

TONY: In practice for an institutional investor, if they are going into these sorts of markets in the first place initially they will want to do it through the stock market which does provide a mechanism both for getting in and getting out relatively easily. To then start going to the next stage of private equity or infrastructure investing, you have got to accept that you are going to be locked into that investment and that country for a very long time so you have got to have high confidence both in the growth prospects for that investment and the eventual ability to realise it.

NOEL: **What time length would you expect to be allocating your assets to a frontier economy for?**

TONY: When we make an allocation we don't make it for a finite period of time but on an indefinite timescale looking at it from a pension fund point of view. We would reconsider that decision if we felt the fundamental attractions of frontier markets in general had significantly deteriorated.

NOEL: **Do you believe that a recession in the developed market place would play into the hands of being in frontier markets which may offer some degree of de-correlation from the developed world, or do you not believe that they are de-correlated at all?**

TONY: It reflects the fact that we talk about frontier markets as a group but when looking at the composition of a frontier index, like the MSCI, it is a whole range of markets. Some are very export and commodities orientated and others have vibrant domestic economies. Part of the skills that you would expect from an investment manager investing in this area would be to trade and benefit from those differences in different global economic conditions.

NOEL: **What do you regard as the pitfalls that institutional investors face**

when investing in frontier markets?

TONY: It's essential to recognise this as a longer term story based on economic growth and stock market development. One pitfall would be if the investor was going in for a quick profit and a sharp turn around. The investor needs to accept that looking for a higher return is usually associated with higher volatility. In reality, an institutional investor needs to be convinced that frontier markets can outperform emerging markets to a sufficient degree to justify these higher risks. I say 'justify' because those risks are more apparent than real. Another reason for investing in frontier markets is to benefit from diversification. But these markets are seen as 'risky' and are susceptible to the reversal of the so called risk on risk off trade which we've seen happen this year. Both emerging and frontier markets have fallen roughly 17-18% per year to date. MSCI Africa, which might be considered to be the most risky region, has actually fallen by 22%. Correlations with developed markets are themselves volatile from the perspective of an asset allocator. There are specific pitfalls for different markets which have to be investigated by the asset owner or the asset manager. Pitfalls aren't greater just because the markets are designated emerging or frontier by the index compilers. If you stick to the BRICs markets, the ability to enforce contracts in the courts is pretty limited in more than one of the BRIC countries!

NOEL: **There are many myths surrounding investing in frontier markets such as; corruption and legal enforcement of contracts. How as an investor would you do that due diligence and ensure that this is something that you feel comfortable with?**

TONY: Most institutional investors would use a specialist manager to form an overall view of the degree of corruption in each market. I was an investor dealing directly with investing in emerging markets for over 20 years. You get a sense for what is going on in a country and how deals get done, how conflicts are resolved, what are the limitations to corporate governance and the extent of insider trading and so on. There has to be some degree of acceptance that these are the prevailing practices in the country but the crucial question is whether you as a minority investor are going to be so seriously put at a disadvantage that it's going to prevent you making decent investments and earning decent profits.

NOEL: **So you have a degree of tolerance to business practises in frontier markets and may not stand up to the benchmarks that could be set for a U.K or U.S company. However, that doesn't make them non-investable just because they aren't reaching those benchmarks?**

TONY: Yes although I would emphasise that this is my personal view. As far as a stock market investor is concerned you are going in as a minority investor. A lot of the emerging and frontier investment managers get quite actively involved in corporate governance issues and with the management boards of those companies. It's about applying enlightened self-interest. You have got to have on-going vigilance and make sure that the company is being run in a way that you are more or less satisfied with.

NOEL: **What can the investment bodies and governments of frontier markets do to entice foreign asset owners more in their burgeoning economies?**

TONY: Capital investment is essential to sustain economic growth but that alone is not sufficient. India seems to have found a development model which overcomes enormous deficiencies in infrastructure by concentrating on services, particularly I.T. services, whereas China by contrast has led with extraordinary high levels of fixed asset investment, particularly in housing and transportation. There is no one key model to adopt but if you are investing for the longer term you need to look at the model for development and see whether it has long term sustainability. Whether it is direct investment or stock market investment, countries need to adopt non-bureaucratic, simple, fast and transparent regulatory procedures. Capital accounts should be open so money can be transmitted in and remitted out. China has a relatively closed account but because the returns have been so high, foreign companies investing there have been quite happy to re-invest. Eventually however they will start wanting to take some money out. Where the commercial code is deficient compared to best practice, the government has got to give priority to getting new laws enacted. Local companies should be obliged to have a comprehensive annual audit by a recognised firm and use international accounting standards. This is important because often foreign investors put money into companies controlled by governments or private groups so are minority shareholders. Governments need to actively facilitate their stock markets to encourage foreign institutional investors. You've also got to encourage the domestic investor base which will create greater depth and liquidity in the market and attract foreign investors. I feel frontier markets could encounter difficulties in this respect where domestic financial institutions have been acquired by large foreign counterparts and key decisions are taken at head office and not locally. This has been the case in Eastern and Central Europe. The problem is these foreign owned institutions may not have the same interests in developing the local capital markets and I would even say, on the contrary, together with the carpet baggers from the global investment banks, they may well encourage companies to list offshore in developed markets. A good example here are the larger mining companies in Euro Asia which have been attractive by the valuations they can gain by listing in London and the liquidity of the market here. Institutional investors should be indifferent to where a company is listed, but this does tend to limit a country's nascent stock market to to local smaller companies. The answer is to open the door to foreign institutional investors and ensure there are no ifs, buts or restrictions.

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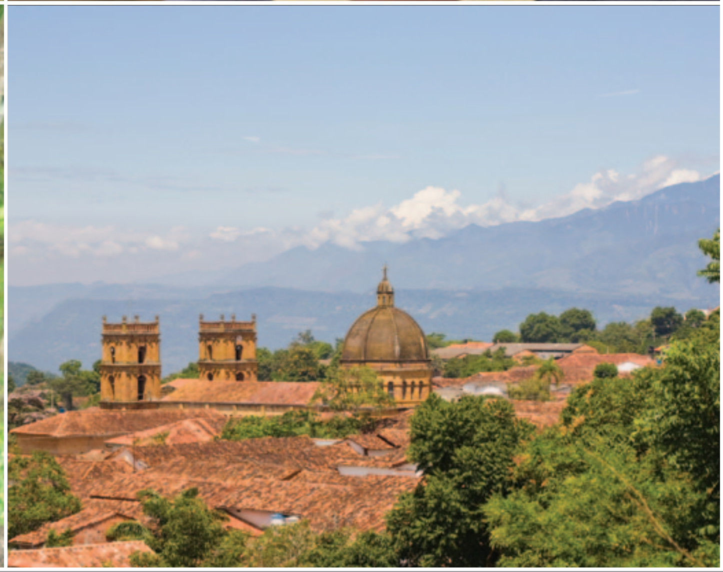
The Pachamama Biodiversity Bond



Pachamama Forest is a sustainable forest developer seeking investors to assist us in expanding the size of our plantations in South America. The PBPB allows investors to profit from one of the worlds most consistent commodities, while becoming a powerful force in the fight against deforestation, climate change and habitat loss.

Pachamama will become a market leader by providing sustainably sourced, FSC approved timber products that have positive environmental and social impacts. For every bond purchased, one hectare of primary forest will become part of the National System of Protected Areas ensuring long term protection.

We currently own 1820 hectares of productive land capable of planting 1.5 million Acacia trees. Pachamama has already planted 50,000 trees with 400,000 planned for 2012.

For more information:
Please visit: www.pachamamaforest.com or contact Byron Lantier at +44 02 07 24 17 469

2011-2020
United Nations Decade on Biodiversity

SPECIAL WHITE PAPER

MINING INVESTMENTS IN THE FRONTIER: OPPORTUNITIES & CHALLENGES

SACHA BACKES
Investment Officer
International Finance Corporation

Long term economic fundamentals suggest an increased future global demand for minerals. With most new mining opportunities being discovered in frontier countries, companies need to be proactive in mitigating political risks by obtaining a "social license to operate", forming transparent relationships with national stakeholders and finding strong partners, recognizing that high commodity prices may raise issues about the fairness of deals and sharing of benefits.

> *"China accounted for around 14% of the global economy in 2010."*

Growing resource demand in developing countries and the relative resource richness of frontier countries has been drawing mining companies to jurisdictions many previously avoided.

The remarkable recovery in metal prices and the positive outlook for minerals following the 2009 downturn has been driven by continued strong growth in developing countries, especially China. China accounted for around 14% of the global economy in 2010, with strong expected 2011 and 2012 growth of around 8% to 9%. Rapid urbanization and industrialization is driving this growth; China is expected to consume 6.9 billion tons of refined copper in 2011, compared to 3.1 billion tons in Europe and 1.8 billion tons in the US (source: ICSG).

While the extent of the economic decoupling of developed and developing economies can be debated, most commentators expect continued growth in the developing world. On the other hand, declining average resource quality appears to be outrunning technological and economy of scale offsets that for many years kept prices low. Thus, despite continued global economic woes centered on the developed countries, mineral prices are expected to remain fairly high in the short and medium term, generating good margins for the industry despite significant cost pressures, and spurring mineral exploration and the significant investment needed to bring new mining projects into production.

The greatest potential for new discoveries and major new developments is in the relatively underexplored and less developed countries of Africa and elsewhere. Major new mining activity in recent years has been seen in West Africa, especially Mauritania, Guinea, Sierra Leone and Liberia, in addition to the traditional African mining heartlands of South Africa and Zambia. The African continent hosts over 40% of the world's gold, aluminum, cobalt and chromium reserves; over 60% of platinum group metal reserves; over 85% of manganese and diamond reserves; and over 95% of vanadium reserves. New exploration and the development of long known-about but undeveloped resources present compelling investment opportunities for traditional international mining houses, new competitors from rapidly industrializing developing countries and in some areas, local and regional mining companies. Two notable examples of world class new mining investments getting underway are the huge greenfield iron ore and copper projects located, respectively, in Guinea (Simandou) and Mongolia (Oyu Tolgoi).

This increased focus on the frontier brings with it important issues for mining companies, linked primarily to host-country governance, often made worse by under- developed legal systems, low public sector capacities and corruption. Governance risks can be further exacerbated by fierce competition for access to good resources and high commodity prices.

> *"Mineral prices are expected to remain fairly high in the short and medium term, generating good margins."*

High prices can bring problems because, while metal prices are volatile, fiscal terms, as laid down in national policy documents or negotiated investment agreements, typically do not cope well with rapid price fluctuations. When prices are high, governments can perceive that they are getting too low a share of windfall profits, leading to pressures to re-negotiate.

Conversely, when prices are low, the industry can struggle with taxation terms that were bearable at higher prices, but which do not reflect marginal profitability. This issue is not confined to frontier countries, as the ongoing debate in Australia regarding the "Minerals Resource Rent Tax" illustrates.

> ***"Mining communities are more prepared than before to make their voices heard."***

Countries that have been through the commodities cycle a number of times, with strong government capacity and a robust political debate, are more likely to take a reasonable route to renegotiation that works to preserve continued investment and reasonable reward sharing. Countries with less experience, governance capacity, and political checks and balances are more likely to act in rash ways that threaten longer term investment sustainability. In some cases, expectations around huge "nation-changing" projects can build up to unrealistic levels and projects become the focus of intense political and public debate that drives government actions.

Greater competition for projects is also leveraging host government bargaining power, as new entrants, especially from Asian countries with major resource requirements, can present different terms and value-add to governments than those offered by western companies. For example, in recent years Chinese firms have been actively acquiring stakes in mineral projects across the African continent, often also providing funding for local infrastructure such as rail, ports and power, a frequent constraint in frontier countries that can significantly increase project costs. These transactions often include conditionalities, such as future product off-take. Three notable transactions include: Shandong Iron and Steel's US$1.5 billion investment into the Tonkolili iron ore project in Sierra Leone; Minmetals' proposed US$1.3 billion acquisition of Anvil Mining for copper projects in the Democratic Republic of Congo (DRC); and Jinchuan's proposed US$1.1 billion acquisition of Metorex for copper projects in Zambia and the DRC.

Communities impacted by mining operations expect a local sharing of benefits, mainly in the form of local investments, sourcing and employment, but in some cases also through a direct share of project revenues. Mining communities are more prepared than before to make their voices heard and take an activist stance if necessary, often supported by local or international non-governmental organizations (NGOs). For example, Peruvian civil society is well known for its active engagement in protecting the interests of communities. A related challenge is mining work forces that have become more active in protecting worker rights. In 2011, strikes caused disruptions at mines in South Africa, Zambia, Kazakhstan, Indonesia, Peru and Chile.

Changes to investment terms have also been fairly prevalent. In 2011 mineral royalties have been increased in South Africa, Ghana and Peru, and the same are being considered in Tanzania, and re-considered in Zambia. Mining contract re-negotiations were carried out during the last few years in the DRC and are due to start in Guinea, following the introduction of a new mining code in September 2011.
The issues above translate directly into risks that may be especially difficult for mining companies working in the frontier to manage. As a result, companies need to be more proactive than before in identifying and mitigating these risks. Key elements in this effort should include: (i) building strong and sustainable relationships with local communities, thereby obtaining a "social license to operate"; (ii) ensuring a transparent and regular dialogue with host country government counterparts regarding project economics, especially costs and the likely phasing of tax and other payments; and (iii) seeking partnerships with reputable groups and / or strategic partners that can provide a "stamp of approval", technical support and/or deep pockets when things go wrong.

> ***"Companies need to be more proactive than before in identifying and mitigating these risks."***

Obtaining a social license to operate through effective local stakeholder engagement reduces the likelihood of local disruptions. Companies often struggle to find a balance between effective community engagement and overpromising or unduly raising expectations regarding future investments or benefits. Junior companies, in particular, sometimes appear ill-equipped to meet these challenges, being often lean on the ground and focused on putting their dollars into the ground through exploration drilling campaigns. This is risky, as the cost of good quality local stakeholder engagement for early-stage projects need not be great and some work can be outsourced, so long as there is informed management buy-in. Local stakeholder engagement can also reduce local costs through local sourcing and employment, and increase security of local operations. Good relations with local communities may even increase the attractiveness of a project to a potential acquirer and crucially make it in the government's interest to facilitate the project.

A transparent and regular dialogue with host government counterparts is critical in forming effective partnerships that

"Good relations with local communities may increase the attractiveness of a project to a potential acquirer and make it in the government's interest to facilitate the project."

reduce the reasons and opportunities for host governments to obstruct or change the terms of project developments. At a time when governments are under increased pressure to deliver development benefits to their communities, resource projects that deliver this at the local community and national level are going to be attractive to them. Of particular importance is transparency and understanding of key issues, such as project costs and the scale and timing of expected developments and project benefits. A common understanding of project risks and what each side is expecting should help facilitate new agreements when circumstances require it.

Finally, one or more strategic partner should be a key element in a company's risk mitigation strategy. The choice of strategic partner depends on the company's strengths and weaknesses: a major mining company can help a junior company mitigate technical risks and may have deep pockets; a large equity fund may be able to open doors to other institutional investors; while a Development Finance Institution or DFI, such as the International Finance Corporation (IFC), can facilitate the financing of projects in difficult countries, help mitigate political risks and provide support regarding environmental and social (E&S) standards. For example, IFC's E&S standards are embodied in the Equator Principles, which have been adopted by the majority of large international commercial banks, so that companies expecting to seek commercial bank financing from such groups in the future will have to adopt those standards at some point anyway. At the worst of times, such as during the 2009 crisis, the presence of one or more DFI is critical for accessing larger commercial bank financing.

Unfortunately, companies sometimes see communities and host governments as threats, rather than as opportunities for effective commercial risk mitigation. Focusing on the three areas above can help establish an effective commercial and political risk mitigation strategy that protects shareholder value and at the same time assists host governments in achieving greater development outcomes for their citizens, thereby aligning long-term economic and political incentives.

IFC, a member of the World Bank Group, is the largest global development finance institution focused on private sector development in frontier and emerging markets. IFC provides financing to help businesses develop sustainable projects, thereby helping to reduce poverty by creating employment opportunities, supplying essential services, facilitating broader local supply chains and increasing government revenues. IFC aims to increase the amount of seed financing it provides to exploration-stage companies through its early equity mining program, as well as providing support to mid-tier mining companies by participating in project and corporate financing partnerships that will support mining development and expansion. IFC will continue to work with mining majors to develop large projects with the potential to transform national and / or regional economies. IFC's global mining portfolio spans 37 countries, of which 17 are in Africa, and totals more than US$400 million. IFC is also expanding its work in Advisory Services for the mining sector, by providing supply chain SME (Small and Medium Enterprise) capacity building, supporting community engagement so that local communities can benefit more from mining activities, and new programs to help the industry to use resources more efficiently with less impact on the environment.

"Unfortunately, companies sometimes see communities and host governments as threats, rather than as opportunities."

SPECIAL WHITE PAPER

SUCCESSFULLY NAVIGATING THROUGH AFRICAN OPPORTUNITIES IN THE CONTEXT OF THE ARAB SPRING

EMILE DU TOIT
Head - Pan-African Infrastructure Development Fund
Harith Fund Managers

SOMDATT KURDIKAR
Head of International Business
Harith Fund Managers

Harith Fund Managers are the exclusive managers of the Pan-African Infrastructure Development Fund (PAIDF) – a USD 630 million private equity fund. The fund provides growth capital to experienced management teams and established corporates seeking to invest in African infrastructure. The fund also invests in greenfield projects and PPP's in the key infrastructure sectors (like transport, telecom, energy) and has been investing since 2007. The Funds current investors are entirely African – underscoring their belief in the opportunity for investing in Africa and our anchor investor is the Government Employees Pension Fund of South Africa. Based on its current performance across its portfolio, visibility of the pipeline and encouragement from existing investors the fund manager has launched PAIDF2 which will be a US$1.2 billion fund expected to close in the next 12 to 18 months.

WHAT MAKES YOU BELIEVE THAT AFRICA IS A GREAT INVESTMENT OPPORTUNITY?

The African opportunity is now widely understood. With a clear thematic trend of continued growth under-pinned by democratisation process and structural reforms now firmly underway, it is no surprise that a number of countries in Africa are poised for strong economic growth. The table below clearly illustrates this projected trend for the next 5 years.

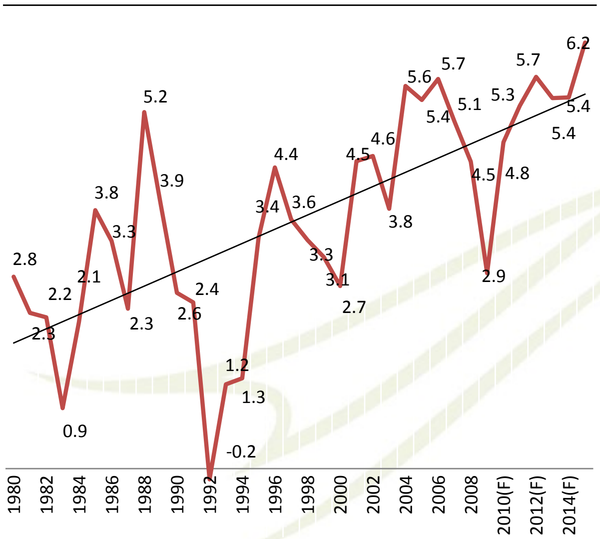
As the provision of infrastructure is a necessary pre-requisite to achieve these projected growth levels, investments into infrastructure projects stand to increase substantially over the next 5 years. Notwithstanding the above, it is clear that there will be short term upheavals in the system as manifested by the events on account of the Arab spring. However, Harith does believe that these are thematically positive and over the long term will only enhance the economic opportunity in Africa.

What is clear is that to navigate these geographies, investors should have vehicles which are on-the-ground so as to be proactive and real-time in monitoring investments; have the ability to structure and de-risk projects by having strong sponsors and credible stake-holders. Last but not the least, have a regional exposure across the continent in order to avoid any single or indeed sub-regional concentration of exposure.

WHAT IS THE TUNIS PROJECT, WHEN WAS IT CONCEIVED AND WHAT WAS ITS CONTRACTUAL STRUCTURE?

It's a Private Public Partnership Project (PPP) where a special purpose vehicle had to be formed. Its obligation was to construct, operate and maintain a new airport. It also had to operate and maintain an existing airport in Tunisia. The right was then for the SPV to receive the aeronautical and non-aeronautical revenues. The PPP is in the form of a concession so there

Africa's GDP Growth, Un-weighted Annual Average,%



Source: Harith Analysis, Economist

World's Ten Fastest-growing Economies*

2001-2010		2010-2015	
Angola	**11.1**	China	9.5
China	10.5	India	8.2
Myanmar	10.3	**Ethiopia**	**8.1**
Nigeria	**8.9**	**Mozambique**	**7.7**
Ethiopia	**8.4**	**Tanzania**	**7.2**
Kazakhstan	8.2	Vietnam	7.2
Chad	**7.9**	**Congo**	**7.0**
Mozambique	**7.9**	**Ghana**	**7.0**
Cambodia	7.7	**Zambia**	**6.9**
Rwanda	**7.6**	**Nigeria**	**6.8**

**Excluding countries with <10m population and Iraq and Afghanistan* are two concessions, one for each airport and each concession runs for a period of 40 years. The first concession of the existing airport commenced in January 2008, and on the new build, construction commenced in July 2007 and was completed in December2009. Operations started immediately thereafter.

Our partner in the project operates a number of airports. They identified and trained local staff and have thus managed to secure the typical skill sets required to operate a successful airport.

WHAT HAPPENED TO THE ASSET AND THE CONCESSION DURING THE ARAB SPRING?

Passenger volumes and air traffic movements was negatively impacted which in turn affectedour revenue stream. There was no impact however to the physical asset. Three other major events had a direct impact on our investment and they are namely; the global financial crash, the Tunisian or Jasmine Revolution within Tunisia itself and thirdly, their next door neighbor being Libya and the multi-national Nato led intervention. All these unforeseen developments affected passenger numbers and airport traffic movements in the region.

On the positive side, the concessions were not negatively impacted because of the scrutiny they went through and the manner of their structuring. The concession agreements were examined by the World Bank and other Development Finance Institutions as well as international investors of the caliber of our partner, TAV Airport Holdings and the International Finance Corporation (IFC).

HOW DID HARITH DEAL WITH THE PROBLEMS THAT AROSE?

Firstly, before the problem arises one needs to choose ones partners very carefully. Our partner is a leader in airport design, development, financing, construction and operation. They've gone through a series of tumultuous events with other airports that they operate, hence all of that expertise has been brought to bear in the Tunisian project. So we had an experienced and highly skilled partner by our side.
In addition to that, we had other experienced partners and co-lenders such as the IFC and the African Development Bank.

Not only did they bring a wealth of credibility, integrity and significant experience to the situation, they also brought composure and focus in times of adversity. One must never underestimate what these institutions bring to the table.

What's also important to recognise is that during the different stages of the recent uprising in Tunisia, the good relationships we have with our equity partners and debt providers, has allowed us to receive constant – almost real time - communication and information about developments within the country, passenger volumes and air traffic movements, political machinations and changes, progress updates and the like. This constant flow of vital information has in turn permitted us to keep our investor base fully appraised and updated as well. We were never in the dark at any given time nor were our investors. We couldn't have asked for better partners!

WHAT IS THE OUTLOOK FOR THE TUNISIAN? CONCESSION GOING INTO THE FUTURE?

In a word – positive. The finalisation of the Tunisian revolution, or the 'Jasmine Revolution' as it's come to be known, now offers the prospect of long term gains. More specifically to our investment, it brings the promise of the new government focusing on stimulating one of its key pillars, tourism. More specifically, we hope that it will negotiate and implement the EU-Tunisian Open Sky agreement which in itself promises further increases in traffic and other related benefits. So overall we have a very positive outlook.

We know it's not going to be instantaneous, but as they say in Tunisia: Inshallah; it's going to be a gradual uptick in returning to the level that traffic was prior to the revolution.

Nevertheless, the Tunisian story is that, in becoming an open democracy following the recent elections, the country will be seen as a more attractive tourist destination which bodes well for our airports.

THE REAL RISKS AND REWARDS; SEEING THROUGH THE HYPE

SPECIAL WHITE PAPER

THE STATE OF PLAY IN AFRICAN POLITICS

CHRIS DERKSEN
Head of Frontier Markets
Investec Asset Management

Despite a year of political upheaval in North Africa, a number of the most significant markets on the continent have turned a historic corner over the past decade in terms of their politics. We expect this trend towards greater political stability, accountable leadership and predicable policymaking in Africa to continue, enhancing the already immense investment potential of the continent.

KEY POLITICAL DEVELOPMENTS IN 2011 AND 2012

By any measure, 2011 was a landmark year in African politics. Two events in particular capture the inexorable transition towards inclusive and accountable political rule on the continent. In North Africa, authoritarian regimes previously deemed as untouchable were toppled by citizens asserting their right to decide who governs over them. And in Nigeria, Africa's most populous state, this right triumphed in an historic election, universally regarded as the most peaceful, fair and successful elections since its return to democracy.

> *"Markets on the continent have turned a historic corner."*

Stepping away from recent and near-term political developments in key markets, it is our firm belief that – with the exception of a few troubling countries – the improvement in the political environment in Africa is widespread, likely to continue and a highly positive contributor to the already compelling African investment story. We have identified five long-term trends that are the direct result of the improved political environment and are enhancing the attractiveness of Africa as an investment destination:

(i) Greater openness to foreign capital: in none of the major investment markets on the African continent is either capital controls or a hostile political attitude towards the movement of capital and investors a major concern or barrier to investment. South Africa and Zimbabwe still maintain capital controls, but these have been gradually liberalised and are not a feature of markets in other parts of the continent. Clearly this has not always been the case, but the political and regulatory environment for foreign capital in Africa is very favourable today.

(ii) More focused political and policy agendas: there has been a distinct trend amongst African government to focus their own attention on a smaller, more realistic and constructive set of tasks – improving education and service delivery, developing domestic infrastructure, and establishing more effective and transparent regulatory regimes than they have in the past. Governments in key markets across Africa are today much more willing to allow domestic and foreign corporations to invest and innovate, rather than try and compete with the private sector or embark on grandiose efforts at state-led development. The more stable environment has also expanded political and policy time horizons, which is conducive to economic and social development and investment in public infrastructure.

(iii) More consistent "rules of the game": economists have long emphasised the importance not only of establishing effective "rules of the game" (referred to by scholars as "institutions"), but also of not changing those rules too often or too radically. In the investment context, we can think of institutions as regulatory policies, legal practices and requirements, capital controls, transparency and disclosure requirements, labour laws, local partner requirements, taxes, etc. One of the most significant barriers to investment that arise from political instability is that the rules of the game are in constant flux - which certainly was the case for decades in Africa. Today we find a much more predictable institutional set-up which is much less subject to dramatic and ad hoc changes in the major African investment destinations.

(iv) Piecemeal regional integration: a key challenge for African investment has always been to establish the scale and geographical linkages required to unlock much of its immense investment potential. Past attempts at integration have failed due to a combination of overly ambitious plans and timelines, as well as conflict and rivalries between countries. On both fronts we see that the political mood has improved significantly in recent years, raising the prospects for effective integration at the regional level: the number of conflicts and wars have declined, and politicians understand that the grand goal of a "United States of Africa" should be shelved until regional integration has been achieved and shown to

> *"The improvement in the political environment in Africa is... a highly positive contributor to the already compelling African investment story."*

deliver clear benefits. The support for regional integration is gathering momentum, particularly in East Africa, where Uganda, Rwanda, Burundi, Tanzania and Kenya will bring different, but complimentary, fundamentals to the table.

> *"Politics dominate in terms of perceived risk factors by prospective foreign investors in Africa."*

(v) Proactive management of natural resources: historically, an abundance of natural resources has been more of a curse than a blessing to most countries. Resource wealth has been shown to have a generally negative impact on economic and political stability and the development of functional institutions and economic diversification. This holds important lessons for the growing list of countries in Africa with vast resource endowments. Encouragingly, policymakers in many of these countries are making all the right noises and have taken initial steps in a direction that indicates that they have taken these lessons to heart. One example is the interest resource-rich countries, including Nigeria, Ghana, Uganda, Namibia, Mozambique and Angola, have shown in establishing sovereign wealth funds as a way of managing resource revenues from a long-term perspective. The emotive issue of nationalisation of mining and resource sectors appears to be completely off the table in most cases (South Africa and Zimbabwe being notable and regrettable exceptions). Politicians and policymakers are focused on encouraging foreign investment, reform and privatisation of key elements of their domestic resource sectors (although some local partnership is typically required).

KEY RISKS

The discussion above paints a generally favourable picture of recent and anticipated near-term political developments in Africa. But is has to be taken into account that, as is the case with the broader African economic growth story, political improvements on the continent are generally starting off from a low base. While the state of play in African politics today is a dramatically improved one from ten or even five years ago, politics still dominate in terms of perceived risk factors by prospective foreign investors in Africa. In a recent survey[1] of investors and executives of major international firms, conducted by Ernst and Young, an "unstable political environment" was by far the most important perceived barrier to investment in Africa, while "corruption" and "weak security" were listed as the third and fourth most important barriers respectively. It is striking that these concerns appeared higher on the list of barriers to investment than other problems commonly identified by policymakers, such as access to skilled labour, poor transport infrastructure and deficient telecommunications.

Part of this reflects the fact that perceptions take time to catch up to reality. It will take time for investors to change strongly entrenched views of political instability in Africa and develop a more granular view of developments on the continent in order to reward countries and regions that show clear signs of improvement. It has to be acknowledged that African countries still dominate lists and indices of the worlds most politically risky investment destinations.[2] Amongst the key risks that our analysts consider relevant are those of external macro factors; the possible mismanagement of reforms within individual African countries, the challenge of navigating the ongoing challenge of income differentials and the potential risks embedded in being resource rich.

THE BOTTOM LINE

As the largest manager of third-party assets in African markets, we are encouraged by political trends on the continent. Our cautiously optimistic view is informed by two main points about the state of play in African politics. First, the direction of change in terms of politics in Africa is positive (even if from a relatively low base). Second, political developments in some of the markets with the biggest growth potential in Africa are looking increasingly positive and conducive to foreign investment. The immediate political future of some of the more mature markets, such as Kenya, Egypt and Morocco (and to a lesser extent, South Africa), is less clear, but we remain optimistic that the long-term trends are positive here too and that markets will rally if political stability is achieved sooner than currently expected. Finally, a number of smaller economies – notably Angola and Zimbabwe – while still lagging behind their peers in terms of democratic politics, have to be assessed from their very unique recent histories. Both these markets remain important from a long-term perspective and we view it as essential to maintain and develop our presence in these countries in light of anticipated future economic and political improvements.

> *"The increasingly positive state of play in African politics will continue to contribute towards what is already a compelling investment proposition across the continent."*

Of course, risks to this largely positive outlook remain – most notably those emanating from the external environment and the uncertainty in North Africa. But on balance we believe that the increasingly positive state of play in African politics will continue to contribute towards what is already a compelling investment proposition across the continent.

1 Source: 2011 Africa Attractiveness Survey, Ernst & Young
2 Notable examples include the Global Political Risk Index produced by The Economist and work by the Eurasia Group and the PRS Group.

ROUNDTABLE DEBATE

What are the Real Risks of Frontier Markets and What do Asset Owners Need to Know to Ensure Solid, Unbiased Information on Investment Opportunities?

MODERATOR:

NOEL HILLMANN
Managing Director
Clear Path Analysis

PANELLISTS:

FAGMEEDAH PETERSEN
Independent Trustee
South Africa (including Government Employees Pension Fund)

RAMON TOL
Pension Fund Manager
Blue Sky group

LINDA MATEZA
Chief Investment Officer
Eskom Pension and Provident Fund

JAMES BEVAN
Chief Investment Officer
CCLA

NOEL HILLMANN: What are the dangers involved with allocating frontier markets and what risk related questions should pension managers be asking if they are considering investing in them?

FAGMEEDAH PETERSEN: One of the biggest risks people don't realise is the capital markets' infantile state of development. The market's small: in Africa only 4 of the listed markets are actually members of the International Federation of Exchanges. You have to be cautious of joining in with a big rush to these markets and creating a 'hot house' effect in terms of the prices of the securities. Because it's an infantile market the information around actual development of deals wouldn't typically follow the private equity path that you have in more developed economies. Not all frontier markets are homogeneous however, so you will find pockets of opportunity that are easy to generate.

LINDA MATEZA: For investors it can be risky to assume that there will be similarities across the frontier markets, they have substantially different economic and financial drivers and investors need to know what is the drivers are and understand the geographies they are investing in. The stage of development of the market is critical to bear in mind. There might be issues around the capacity to absorb large flows of funds as well as investment opportunities for large investors.

RAMON TOL: Since most of our assets are outsourced, we do not invest in frontier markets directly, but indirectly through external managers. We have invested in frontier markets using a global managers which means our frontier market exposure is already diversified across frontier market countries. This reduces country specific risk. Currently, one of our largest concerns regarding investing in frontier markets is geo political risk. The situation in the Middle East is something we keep a close eye on.

> ***"It can be risky to assume there will be similarities across the frontier markets."***

JAMES BEVAN: There are the broader challenges of market arrangements; regulation, ability of policy, controls on capital and currency flows, all of which are clearly important as to whether pension funds are able to achieve the benefits that they would deem to be a probability of faster economic growth.

FAGMEEDAH: Understanding the dynamics of a particular market when you go into it is vital. Many frontier markets' performances are relatively resource based. Understanding the dependency on global commodity prices and on the consumers of the exports is also important.

JAMES: There is a raft of risks associated with the macro environment whether it be political, economic or cyclical. There are interesting micro challenges relating to structure and function of individual companies and therefore also associated with the nature of governance and information flows. There is a great danger that people who buy into a frontier market think that they are going to get the market exposure when they buy a headline liquid stock when actually they need to be very focused on the individual company characteristics.

LINDA: The early stages of development of these frontier markets capital markets means there's little confidence in the security markets and hence there is a lack of liquidity. Share prices' ability to reflect the actual underlying fundamentals s of the economy becomes quite limited as the markets are not as efficient as the more developed markets.

RAMON: Some of these markets are fairly illiquid as well. Since we believe assets in Frontier markets can grow quickly, we need to pay attention to the capacity limits of our frontier market asset managers. Transaction costs can increase significantly when the managers are gathering assets.

NOEL: How can institutional investors ensure solid, unbiased information on investment opportunities?

JAMES: Cross check information and consider both third party commercial research and grass roots confirmation from suppliers, customers and competitors to validate that the story we are receiving is consistent with the facts on the ground is vital.

LINDA: It is critical for institutions to find local partners or other institutional investors who are in the markets and share and verify information. Because of the institutional capacity, which is often not as developed, there are independent or third party sources to rely on, so networks and partnerships become critically important.

NOEL: How do you go about finding these reliable information sources as you mention that it is quite difficult.

LINDA: Sources can be informal for example from private equity partners or obtained by a local partners on the ground. In some African countries, such as Nigeria or Kenya, there are research houses which are able to provide information. Informal sources can be a good source of information that would not normally be available on any public platforms.

NOEL: Fagmeedah how would you go about finding solid unbiased information?

FAGMEEDAH: We have a good group in South Africa called Carlton so when I need information I use them. I don't think that the value of experienced, knowledgeable, independent advisers should be underestimated. Advisers who put reports in front of you have the capacity and experience and being on the ground in the countries where you want to invest is crucial to understanding the dynamics in the market. I'm a member of a subcommittee of a private equity fund that invests in Africa and we found that once we had made one deal in a country it became a lot easier to gather information about other prospects in that country. In Africa there is the Africa Development Bank (ADB) who is a huge partner for a number of typically private investors in Africa making information available like general background information on the countries and industries in the various countries. That re-enforces the informal network that Linda refers to although I think ADB probably have a more formalised role in terms of encouraging business in Africa in particular.

> ***"The value of experienced, knowledgeable, independent advisers should not be underestimated."***

RAMON: The frontier market asset manager is responsible for stock selection. They are in touch with the underlying companies, suppliers, customers, competitors and even government officials and regulators on a regular basis. Some of the asset managers have already established a lengthy track record in managing assets in frontier markets and travel to these countries quite frequently. We prefer them to have local presence or at least "field" experience. In order to verify macroeconomic conditions in frontier markets, we compare research information from asset managers as well as independent third party research. The asset manager eventually makes the top down and bottom up decisions.

JAMES: There is a broader issue in terms of the institutions in frontier markets that govern the quality of information and therefore by definition the ordered arrangement and the compliance with international accounting standards. We are much more interested in spending time investigating situations if we believe there is reliable accounting and information which we can base our judgements.

NOEL: Thinking of verifying the quality of the formal networks, how would you go about verifying the quality of a formal independent research provider?

FAGMEEDAH: Good consultants are referred to potential clients by other users. The success of the investment strategy that they have developed for their existing clients will play a huge role as to whether they get referred. I've had the advantage of being exposed to the asset consultants of a number of different clients and that gives me a very good basis for comparison and the range of issues that they consider when they are developing a frontier market strategy.

LINDA: I would add that the reputation of the consultants as well and their integrity is important. Sometimes that is all you can rely on. A professional and reliable consultant company wouldn't go out of their way to obscure information or to misrepresent it. In some cases, investors just have to have faith in the integrity of the consultants that are referred to them.

NOEL: Are institutional investors who do not allocate to frontier markets missing the boat. In answering this question could you state which continents you are allocated to or interested in?

RAMON: Currently we have 2% of our equity allocation invested in frontier markets. We have hired two active global frontier market managers and they are allowed to manage global frontier country and sector exposures actively. We are 1% below our target allocation which is primarily due to the political turmoil in the region as well as the global macro economic uncertainty. Since these markets are more driven by domestic growth dynamics, they depend less on global economic growth and as a consequence the beta against developed market equities is lower than 1. These markets are perhaps more a defensive play than one would expect. What we've seen in August and September as well as in the year to date numbers is that these markets are performing better than emerging markets. I have just checked the numbers and the MSCI frontier markets index is 400 basis points ahead of the emerging market index on a YTD basis (per September end). There are probably diversification benefits here. The correlation between Frontier and developed equity markets (based on monthly return data since June 2002) is only 0.4. Furthermore, the long term outlook is appealing. Many of these countries have strong macroeconomic fundamentals and healthy balance sheets. They are expected to grow faster (39 of the fastest 45 growing economies are frontier market countries) than both developed as well as emerging markets and demographics are favourable. At 9x 2012 estimated earnings, frontier markets are probably undervalued. There is definitely a case to be made for frontier markets.

JAMES: We are exposed to all of the major regions. The two regions we think look most promising are; Sub-Saharan Africa, where we are actively looking for opportunities to participate in what we believe will be relatively strong population growth and economic vibrancy over the decades ahead. Pockets of Eastern Europe are interesting and our challenge has been that Euro land project has thrown up some very interesting opportunities in economies. Czechoslovakia we believe will be an area that represents a good opportunity for institutional investors to make sensible returns in the years ahead. There are a lot of pension funds that simply say it's in the 'too difficult' box and thereby they short change their beneficiaries from higher and well diversified rates of return which are clearly necessary in order to live off appropriate pensions over the long haul.

FAGMEEDAH: I'm involved in South African pension funds and are looking to invest further in Africa. It's quite a bit of dichotomy to the story 'missing the boat or not'. Africa's listed markets have been extremely volatile and so for the year to date anyone who hasn't gone into Africa has breathed a sigh of relief. Private equity has been far more fortunate in terms of avoiding casualties and so they have perspective,

"The long term case for investing in frontier markets is very attractive indeed."

they have managed their market related risk by going into private equity investors. If you don't consider the African scene you are sacrificing the very youthful demographic opportunities that Africa presents. We are talking; forestry, livestock, grains and a number of agri funds that have come to the markets for Africa in the last few years and they are expected to do great things.

LINDA: Our fund is invested in Sub-Saharan African private equity and we are looking to invest in listed equity. At this stage we don't have exposure outside of South Africa in the listed markets; it's all within the private equity market. In terms of whether institutional investors who don't allocate to frontier markets and Africa especially would be missing the boat, I would say that it depends on their strategy and where they see opportunities over the longer term. I have a philosophical problem with the idea that everyone should be in frontier markets because the dynamics of different funds and different institutions are quite different and might call for varied investment strategies. It depends on how compelling they find the long term investment case for frontier markets.

NOEL: What type of funds should not be investing in frontier markets and which ones should you certainly be looking at with regards to frontier markets?

LINDA: A fund that requires a lot of liquidity could only invest a small portion of their portfolio in frontier markets. There are fewer companies listed and fewer investment options, and often shares are held for the long term by local investors and institutions and there might also be capital account restrictions for foreign investors. If a fund has a very low risk tolerance, then the currency volatility in the frontier market as well as the movements of the stock markets themselves might be too much to bear for funds that are very conservative in their approach. It is probably not a strategy for everyone. In my view, the long term case for investing in frontier markets is very attractive indeed.

JAMES: There has been a tendency amongst trustees to assume that the cost of transacting, including local taxation are broadly similar to developed markets when in fact they can be a great deal higher. There needs to be a much longer time applied when contemplating which course of action to follow.

RAMON: I fully agree with the last two views. These are markets you want to invest in for the long run. You don't want to frequently re-balance your positions in these markets. We try to leave our frontier market managers out of our re-balancing programs and will only fund or withdraw once every two years. Since inception of the two funds in June 2010, we have never withdrawn any money. It wouldn't surprise me if transaction costs in these markets are more than 100 basis points. That is definitely something you want to take into account when rebalancing, especially when markets are volatile and characterized by political turmoil or macro economic uncertainty.

NOEL: On that final note from Ramon I'd like to thank everyone for joining me and for sharing your views.

SPECIAL ROUNDTABLE

WHAT LESSONS CAN BE LEARNED AND OPPORTUNITIES SEIZED FROM THE 'ARAB SPRING'?

MODERATOR:

ELIZABETH KEACH
Publisher
Clear Path Analysis

PANELLISTS:

MAGDA KANDIL
Executive Director & Director of Research
The Egyptian Centre for Economic Studies

SERDAR SAYAN
Dean, Grad School of Social Sciences, *TOBB University*

ELIZABETH KEACH: Thank you both for joining me today. In light of the social and political turmoil that has swept the Middle East and North Africa this year, what are the economic consequences and where are we seeing upside and opportunity for investment?

MAGDA KANDIL: If I take Egypt as an example, the economy has taken a big hit post-revolution which is not the result of the revolution as much as the result of the lack of focus, vision and instituting the right policies to establish more confidence- particularly amongst investors- and proceeding with the recovery process. The various indicators that we have seen suggest that the economy may be slightly better than compared to the first quarter of this calendar year but none the less, the economy is not quite on its way towards recovery. The main pockets that have seen quite a bit of devastating impact remain very much shaken which has resulted in the loss of confidence.

Regarding upside, we are optimistic that post-revolution we will address the concerns of many Egyptians, which would have had a drag on the economy, even without the political ramifications. We're addressing the corruption and establishing better governance, rules of law, diversifying the economy and raising the standard of living for many Egyptians who had suffered before the revolution in a growing economy. We thought that this would strengthen the fundamentals of the economy to position Egypt as a better prospect going forward. Unfortunately the transition period has proven to be quite problematic and we are not quite out of the woods yet, but we do remain positive regarding the outlook of the economy once we cross the road. Hopefully the upcoming election results will help bring more confidence to the economy to move it forward.

SERDAR SAYAN: I completely agree with Magda's comments regarding resisting corruption in the after math of the transition and a better investment climate in general, which is what we are hoping for. In the short term, both the Tunisian and Egyptian economies took a blow. The same would be true of Libya although it is too early to see the damage as of yet. I have World Bank numbers that show Egypt had a growth rate of 5.2% in 2010, and that is estimated to go down to 1% by the end of this year.

MAGDA: The 1% was projected by the IMF. The official number is 1.8% because the last quarter of the fiscal year in June turned out to be stagnant. It was not contraction as they expected. The overall performance for the year was 1.8% and most of that was attributed to the first half of the fiscal year before the revolution through December 2010.

SERDAR: That is great but the point remains that there has been a significant reduction in growth rates. The same is true about Tunisia although to a lesser extent. Unemployment is also up. In Egypt investment has shrunk by 26% and tourism revenues have been negatively affected by the whole process. Tourism accounts for more than 10% of the GDP. The reduction in tourism revenue is huge for the Egyptian economy. In the short term, we expected all this, but again, it is very early for the Egyptian and Tunisian economies to be evaluated even on the short term prospects. They say that ongoing research indicates that transition periods after major upheavals last around a year. My expectations would be slightly longer for the Tunisian economy. Within at most a couple of years the Tunisian economy will be going back to its pre transition pace. Maybe it will take a bit longer for Egypt, but after the transition is completed, things will be a lot better. I expect that both countries will restore political and macroeconomic stability and go back to their pre transition growth paths in not too distant a future. They will achieve even higher growth rates in the medium to long term, as they gradually liberalise their domestic markets and foreign trade regimes in a more democratic environment.

There are a number of challenges in the short term. Unemployment is a big problem particularly in Egypt. Income distribution needs to improve and poverty must be reduced. Food prices may play a critical role in this context. If food prices go up, the transition may prove more difficult, but in the medium to long term I see better prospects for both economies as compared to pre transition political regimes.

There are upsides. Increased political stability is good for economic growth. We experienced this in Turkey. We had a huge financial crisis in 2001 and we cleaned our house in the aftermath of that crisis. We have given a comfortable majority to one party in all elections since 2002, and with increased political and macroeconomic stability, have continued with the liberalisation. Turkey is now achieving rather high growth rates despite the global recession. So I expect a similar development to be observed in Tunisia and Egypt, as they liberalise their markets and foreign trade regimes and improve their business climates. Start up businesses are on the rise and Egypt seems to be a good destination particularly for firms from different emerging market economies.

ELIZABETH: **Magda did you want to respond to that?**

MAGDA: With regards to the short term risks, I would also mention the fiscal risk. Egypt just got downgraded by Standards and Poor's, the economy has taken a big hit by the revolution but also economic policies cannot be relieved from responsibility for some of the continued deterioration in economic activity and rising inflation.
Inflation is high. It is about 12% in Egypt. Unemployment is high, it is about 12%, because the scope for jobs is mainly in the private sector and the private sector has taken a big hit post the revolution. The government has taken charge of the economy but mainly by widening the fiscal deficit. Most of the spending has been catering to consumption based support. They've been accommodating a lot of demands that have grown since the revolution and have escalated to widening the fiscal deficit and increasing the bill for the government. Fiscal consolidation is a must, particularly when we look at the items that the government has been growing since the revolution and the fact that it has been very consumption based support.
The transitional government has found it easier to accommodate the demands of increasing wages, salaries and increasing consumption support, at the same time the government has been borrowing at a very high rate. It is no secret that we have lost about 11 billion US dollars of international reserves since the revolution and major sources of foreign income have not recovered. Surprisingly, in the last fiscal year (ending June 2011) tourism only went down by 1 billion dollars compared to the previous fiscal year. Most of the good performance was attributed to the 6 months before the revolution through December 2010. The picture is distorted by the fact that the past fiscal year spans 6 months before and then 6 months after the revolution. On the positive side also, remittances went up in the last fiscal year, exports are up and Egypt is benefiting from being an energy exporting country due to the rising energy price.
Policies that should now be implemented are highly needed to establish a proactive agenda to help the private sector, particularly small and medium sized enterprises. Big investors may not be intrigued to come back until political stability is fully restored. The transitional government needs to reform public finance, it needs to prioritise fiscal spending, mobilise additional revenues and set a limit for expectations particularly on the social front.
Finally, the transitional government needs to capitalise on international support. There have been lots of pledges that are yet to be mobilised because most of the pledges are in the form of project based support and it's high time that the Egyptian government puts together a plan to mobilise these funds into action in order to help get the economy moving forward. If we work on these dimensions; helping small and medium sized enterprises, reform public finance and prioritise spending towards fiscal consolidation and mobilising international support, the results will help ease the tension and graduate the country quicker from a transitional period that has proven to be costly. After that, the economy most likely will be in a better position to reap the benefits of political stability, reinforced by its strong fundamentals.

ELIZABETH: **Serdar, what are your opinions on whether European and North American institutional investors should consider the region for investment?**

SERDAR: The outlook seems bright. The investment climate will be improving, economic stability will be restored, hopefully political stability will come back and the riots will stop soon. This will allow Egypt to borrow from international markets at a lower cost and growth will pick up. Higher growth rates will make it easier Egypt to deal with high rates of unemployment, particularly among the young. As a result, the large young population may prove to be an asset for the whole economy, as it may mean a larger population with a higher purchasing power.
I would think that following the restoration of political stability and the reduction in risk factors, North American and European firms will seriously consider investing in Egypt. I can think of one challenge to stand in the way of reaping benefits from the regime change and that is the military's role in Egypt. This may prove to be a big obstacle to liberalisation. The military has huge holdings of companies in Egypt so we will see what is going to happen in the aftermath of the revolution.

ELIZABETH: **Could you explain that a bit more for those who are unfamiliar?**

SERDAR: The Egyptian army acts like an entrepreneur. They have shares in many companies and they have set up many companies. They are one of the largest stakeholders in the Egyptian economy. So they may resist change, as under the old regime they were pretty happy. However, in this new era, the army's role in the economy should be restricted to getting rid of the old regime that feeds political instability, income inequality, corruption etcetera. Gradually at least, the Egyptian military should remove itself from economic activity so Egypt can create a better climate.
Regarding opportunities, we are talking about a young population with an increasing appetite for consumption. Thanks to globalisation, they closely follow changes in consumption patterns in the rest of the world and they demand similar products. As unemployment rates gradually decline, their purchasing power will increase,

especially after the chaotic era has been left behind. Certain sectors such as tourism and telecommunications will be better areas to invest for even European and North American firms, but as they tend to be more risk averse than firms from emerging market economies, they may be more hesitant to come in light of the current uncertainties. Still, business, particularly south-south business will continue to flourish, in both Egypt and Tunisia.

MAGDA: The experience of Egypt is that the economy has been mostly driven by resilient consumption. This resilience has protected the Egyptian economy during the global financial crisis, aided by fiscal stimulus. Egypt's economy pulled a 4.7% growth rate in 2008/09. If you look at the main contributors to growth, resilient consumption has been among the main drivers in Egypt. Even without the revolution; this model may not have been sustainable, because wealth was not trickling down in a growing economy. Many Egyptians were feeling the pinch of deteriorating standard of living due to a higher cost of living and not being able to grow their income with the cost of living. At the same time unemployment was rising. If Egypt can address these two factors going forward with the right economic policies, then investors can capitalise on a vibrant economy that is young, supported by growing jobs for the youth to help them contribute to the production basis of this economy towards sustaining consumption going forward.
From an investment point of view the Egyptian economy offers an 85 million population, resilient consumption and a young population that offers a lot of sustainability to grow consumption going forward. The economy has been striving to cope with a higher standard of living and in many respects consumption patterns have been growing reflecting positively on the quality of living.
To address the Egyptian economy since the revolution, instability surrounding the removal of the previous regime was relatively brief. As a result, infrastructure remains pretty much intact. The economy has not suffered major destruction in terms of roads and structures, which bodes well for investment. In addition to that, Egypt historically has been a very strategic location; from an investor's point of view. Once established in Egypt, investors have a gateway to grow their business and expand exports in a number of directions. They have a gateway to the south in Africa, to the Gulf with a very high standard of living and very upbeat prospects for domestic consumption. They also have a gateway to Asia and Europe. Also, keep in mind that the more advanced economies are not doing well at this point so investors are looking south and emerging markets are likely to fare better.
Regarding the military, I beg to differ with Serdar. The concerns about the military involve the political process. There has been a lot of scepticism about their genuine demands to give up authority and transfer this to a civil government going forward. I generally subscribe to the idea that they genuinely want to get out of power but they want to make sure that the process is in place to transfer leadership peacefully and that the power players for succession have emerged to provide them all the space and the scope to transfer the power without any hesitation. As far as their economic involvement is concerned, I believe most Egyptians do not feel badly about the military involvement in the economy as they are not owning as much as contracting and contributing to the execution of many projects. It is well known that the Egyptian army has benefitted from US AID in particular so it is a wealthy institution and has its own financing, but none the less, they are known to be very efficient in delivering on their commitments and swiftly delivering and committing their productive resources. The scepticism is more focused on their genuine plan to hand over power and how soon they would do that. I'm hoping that they will, this is just my personal opinion. All in all, I would give my thumbs up to investing in Egypt, from an economic and investor point of view, given the strengths of the economy's fundamentals and the outlook for its future.

ELIZABETH: **That was a very interesting point about the South to South relationship.**

SERDAR: It is an emerging area and we should pay more attention to that. During the recession, the demand from developed country markets has fallen and south to south business emerged as an alternative. Egypt, and to some extent Tunisia, could benefit a lot from that. There's greater interest in the Middle Eastern markets among Turkish and Latin American firms, for example. A large domestic market is an advantage and makes it easier to attract foreign firms. The regional growth would also have spill over effects for transitional countries. Oil prices would play a critical role in that. If oil prices rise, and food prices decline in the months ahead, that will certainly be beneficial for the Egyptians and other frontier economies. Falling food prices would certainly allow poorer sections of societies in transition to shoulder the burden of the slow down in economic activity more easily.

ELIZABETH: **On that note, I'd like to end and thank Serdar and Magda for joining me.**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