Looking for higher yields? Get the right blend

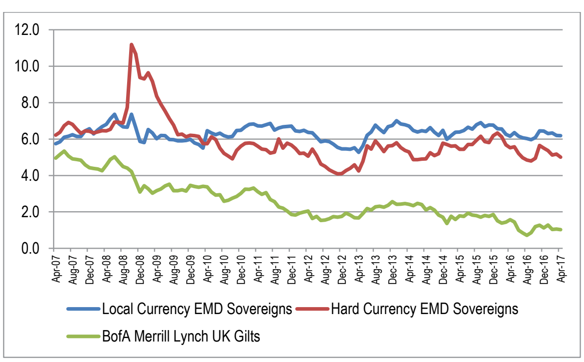
Nicholas Hardingham reveals how undertaking a blended approach to emerging market debt can provide attractive results for investors

As more investors look outside traditional government bonds in order to generate a reasonable yield in what is a historical low-yielding environment, emerging market debt (EMD) has been a significant beneficiary of the reallocation. We believe that taking a narrowly-focused approach to EMD is sub-optimal in achieving diversification from traditional fixed income portfolios. Our analysis indicates an allocation to blended EMD categories provides the most attractive diversification outcome.

Over the past decade, we have seen the EMD asset class grow significantly in size as more issuers have come to market, which in turn has increased the opportunity set available to investors. In spite of this, yields for EMD remain attractive in comparison to their developed market peers, and in line with their longer term historical averages (see Chart 1 below).

Recent inflows have helped support strong returns delivered by many EM sovereigns and corporates, but a lot of this capital has been placed into more traditional, often investment grade, EM issuers. They may appear to offer a lower risk entry point to the asset class but this in turn concentrates investors' risks and diminishes the potential diversification benefit.

Chart 1
EMD yields are relatively attractive
Yield to Maturity of Average Benchmark Indices (%)
10 Years to 30 April 2017



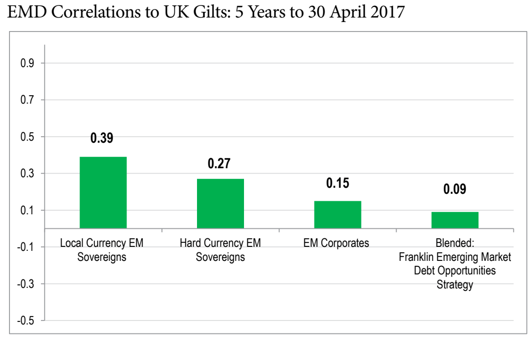
Data source and basis: see below.

Diversification and an active approach

EMD can be classified into three broad categories: local currency sovereign debt, hard currency sovereign debt and hard currency EM corporate debt. Their qualities in diversifying traditional fixed income assets vary from good to excellent as can be seen in Chart 2 below.

By applying a blended approach to the asset class, pension schemes have the ability to better diversify an EMD allocation in relation to a broader fixed income portfolio. Active allocation has the potential to improve the outcome even further, exploiting the diverse nature of EMD. Added to that, an unconstrained manager has the freedom to avoid large exposures to markets or sectors that dominate indices, which are often more correlated to core fixed income, whilst still capturing the high yields on offer. This is the approach adopted within Franklin Emerging Markets Debt Opportunities strategy.

Chart 2
Low correlation to gilts
EMD Correlations to UK Gilts: 5 Years to 30 April 2017



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Data source: Franklin Templeton Investments, Barclays POINT as at 30 April 2017. Local Currency EM Sovereigns are represented by the JP Morgan GBI-EM Broad Diversified Index; Hard Currency Sovereigns are represented by the JP Morgan EMBI Global Diversified Index (Chart 2: GBP-hedged); EM Corporates are represented by the BofA Merrill Lynch Emerging Market Corporate Plus Index (GBP-hedged); UK Gilts are represented by the Bank of America Merrill Lynch UK Gilts Index. Due to differences in calculation methodologies between our internal risk database and official benchmark provider, these statistics may not match the official statistics of the benchmark provider.