



Debt worth having?

➤ **Whilst emerging market debt has traditionally been a small proportion of pension schemes' portfolios, recent resilience amid market volatility suggests that this could be debt worth having. Sandra Haurant reports**

Against the backdrop of US President Donald Trump's trade war tariffs and violent conflict in the Middle East and Ukraine, emerging market (EM) debt has shown surprising levels of resilience. J.P. Morgan's index of local currency bonds of large EMs rose by around 10 per cent, while the FTSE World Government Bond index, made up of developed markets, rose by 6.6 per cent, according to the *Financial Times*.

Because, while Trump's initial announcement on trading tariffs sent

shockwaves around the world and left many thinking developing economies would suffer most, it appears investors have been increasingly drawn to this sector. EPFR said in May that EM bond funds had seen their biggest inflow in over two years.

It's perhaps not surprising, since it could be argued that these funds provide much-needed diversification, and notably alternatives to dollar-based assets, important in today's context.

In fact, some even argue that these smaller, growing markets could emerge from the trade wars relatively unscathed.

Aviva Investor EM sovereign analyst, Carmen Altenkirch, says: "Returns have been positive across all EM fixed income asset classes, but local currency stands out. Returns, year-to-date, are just shy of 10 per cent. This comes against a backdrop of heightened geopolitical and policy uncertainty. In years gone by, wider spreads would have been par for the course. This year, blink, and you missed episodes of risk-off."

Defined by diversity

EM debt falls broadly into four sections, local currency and hard currency (for example dollar denominated investments), corporate and government (or sovereign) debt.

But what exactly constitutes an EM? There is no real definitive answer, but according to EMTA, the trading association for EMs, the list of countries considered to be EMs usually includes Latin American countries like Argentina, Brazil and Mexico, as well as India, the Philippines, Romania and Russia. Territories including Czechia, Singapore and Turkey are also frequently considered to be emerging, too.

A very eclectic bunch, but there are uniting factors. EMTA says the countries are included in the group generally have some (but not necessarily all) of a number of key characteristics.

This includes a gross national product of less than \$9,385 (around £6,700);

Summary

- The list of emerging markets and developing economies is far from fixed, and the same goes for the ways in which these markets are defined.
- Emerging markets were a cause for concern when Trump's tariffs were announced but have largely turned out to be resilient – particularly against a backdrop where developed markets can be shaken by unpredictable decisions.
- There are four main areas of emerging market debt – sovereign and corporate, local currency and 'hard' currency.
- Traditionally a small proportion of a portfolio for pension schemes, there is room to grow allocations in this field and, according to some experts, good reason to do so.

recent or relatively recent economic liberalisation (for example, a reduction of the state's role in the economy, or removal of obstacles to foreign investment); debt ratings below investment grade and a recent history of defaulting.

Other key characteristics include the recent liberalisation of the political system with increased public involvement and not having membership of the Organisation of Economic Co-operation and Development (OECD).

So, although the term sounds all-encompassing, EMs are far from homogenous. Indeed, says XPS Group chief investment officer, Simeon Willis, "EM debt shouldn't be thought of as one asset class. At one end of the spectrum, hard currency debt and investment grade debt can comfortably sit within a scheme's low risk bond portfolio as a natural diversifier to sterling corporate bonds."

The pension question

Historically, pensions have kept relatively modest allocations to this area. According to the thinktank ODI Global, UK pension funds allocated £14.2 billion to EM in

2022, just 0.5 per cent of assets under management. And yet, ODI Global says that EM bonds have outperformed developed market bonds since 2010.

“EM debt has traditionally been a relatively small part of pension schemes’ portfolios for understandable reasons, but this is steadily changing,” says Willis.

“There are several quite fundamental technical features of different EM debt assets, which have a significant bearing on the role they can take in a pension scheme’s portfolio.

“When combined with suitable hedging strategies, the risk profile is directly comparable to other non-sterling developed market bonds and is an obvious opportunity for schemes looking to migrate to a low dependency low risk portfolio.”

Local currency heroes

But, Willis explains, because the largest component of debt issued by EMs is in local currency, this translates into a significant currency risk which is, says Willis, “very expensive to hedge”.

As a result, he says: “These don’t really have a role in scheme’s low risk bond portfolio. Instead, there can be a role for them in the growth portfolio – but even here the size of allocation needs to avoid being too great.”

Payden & Rygel senior vice president, business development, Dennis Kwist, adds: “In traditional DC (as in the UK), EM debt is very under-allocated, as there is a stronger preference to equities. That being said, Nest has a 6 per cent allocation to EM debt in its most aggressive fund allocation.”

In other parts of Europe, pensions have tended to invest greater proportions of their portfolios in EMs, and funds are available on DC platforms, but, Kwist says, the allocation is lower compared to equities and a home bias remains prevalent.

Still, he says: “The traditional DB pension countries, like Denmark, Finland, Switzerland, and Netherlands,

have had long-standing allocations to EM debt, at about 5 per cent. That has changed little and has somewhat reduced as allocations to private debt have increased. In the Netherlands, with the move from DB to DC, expectations are that high yield and EM debt allocations will increase, as investors will be able to take more risk, but with a need for liquidity.”

“We believe that EM debt can provide attractive returns and help diversify equity risks as members approach retirement ”

Where in the world?

A drive towards EMs could be beneficial for pensions in the current climate, argues Payden & Rygel managing director, Kristin Ceva. But in a field this broad and varied, there are geographical areas that stand out.

“EM debt remains underappreciated despite offering attractive income with 7–8 per cent yields, broad diversification, with up to 80 countries, and exposure across sovereign, corporate, and local currency markets,” says Ceva.

“We see value in local bond markets, including Brazil, Mexico, Peru, Indonesia, Hungary, Czechia, Turkey, South Africa and Egypt.”

For sovereign credit, Ceva cites opportunities in countries such as: “Argentina, Uzbekistan, Paraguay, Costa Rica, Guatemala, Sri Lanka, Mexico, Hungary, Ghana, Zambia, Morocco and Albania, among others.”

And in the corporate space, there are “a variety of interesting opportunities”, Ceva says. “A few we like are Brazilian consumer, industrial and transportation companies, financial and utility names in Mexico, utility and telecom companies in India, Peruvian financials, Guatemalan consumer and Chilean utilities.”

A different future

Looking ahead, of course, there is too much uncertainty for any firm predictions. But it is nonetheless likely that EMs will remain an area of interest on the DC side of things, says XPS Group head of DC investment, Mark Searle.

“For DC schemes, we believe that EM debt can provide attractive returns and help diversify equity risks as members approach retirement as part of a liquid credit portfolio,” he says. Indeed, in a recent provider survey by XPS Group, nearly 80 per cent of master trusts said they had some exposure to the asset class within their default investment options.

Proportions of allocations remain relatively small, but nonetheless form a consistent element in a diversified portfolio, according to the study, he says: “To a greater or lesser degree, the majority of respondents utilise EM debt conservatively within the consolidation phase of the glidepath, though some do have small allocations within growth phases as well.

“In line with our findings for DB schemes, exposure is largely accessed through global high yield bond funds, which are likely to be the strategic allocation rather than selecting EM debt in isolation.”

Ultimately, Altenkirch says: “All-in yield across EMs remains attractive. In many respects, the ‘fiscal fears’ that have plagued EMs in the past, have shifted to developed markets. Comparatively, the risk profile of many EMs investment grade sovereigns is stronger than that of some developed market countries.”

As such, she says, EM allocations could be useful diversifying tool within a fixed income portfolio.

“This is particularly true for pension funds, that are looking for steady returns,” she adds.

 **Written by Sandra Haurant**