For Professional Investors Only.

Go anywhere with your EMD allocation

Cathy L. Hepworth explains the benefits of implementing a 'go anywhere' emerging markets debt (EMD) investment strategy

What allocation trends are you seeing in emerging markets debt?
We continue to see investors make an initial allocation to EMD as they seek to diversify traditional fixed income portfolios. We also see schemes that currently invest in EMD, but want to diversify further into the asset class. For example, while hard currency EM sovereign debt strategies remain in demand, some investors are requesting more formal blended approaches. These include portfolios with a 50/50 allocation to hard currency sovereigns and corporates, or a 50/50 allocation to hard currency and local currency bonds.

Some investors have asked for a custom benchmark comprised of one-third EMD hard currency sovereigns, corporates, and local currency bonds. Still others are looking into actively-managed 'opportunistic' or 'go-anywhere' strategies that can invest across all EM debt sectors. These strategies are generally not beholden to a market benchmark and allow investors to delegate the EMD asset allocation to the asset manager.

Overall, investor allocations reflect evolving internal scheme objectives, whether it is to add more income or gain more diversified credit and/or currency exposures. Some even consider EMD to be part of their scheme's 'growth' portfolio.

Given the strong, long-term performance of EM hard currency debt, why diversify further into the asset class?
Each EMD sector brings its own set of potential benefits and risks, and each has exhibited different performance patterns and correlation trends depending on the economic and market backdrops. For example:

• **Hard currency sovereigns and quasi-sovereigns** tend to perform well in 'risk-on' markets and stable-to-rising interest rate environments. They also tend to mean revert fairly quickly following a sell-off and have a high Sharpe ratio relative to other EM debt sectors.[1] In fact, during the first quarter of 2019, hard currency EM sovereign debt recouped all of its losses from the 2018 sell-off and many segments of this market remain highly attractive.

• **Hard currency corporate bonds** generally offer higher yields and idiosyncratic opportunities with attractive relative value in high-growth economies. They may perform better than other EMD sectors in more volatile 'risk-off' markets as they typically have shorter durations than their sovereign counterparts. However, their recovery value in the event of default is lower than sovereigns/quasi-sovereigns due to the varying rules of law and governance in different countries and jurisdictions. So it is important to be selective.

• **Local rates** hedged may perform well in slowing global growth markets, especially when real yields are high and yield curves are steep. Local currency bonds can offer an important source of diversification and alpha, especially as a manager can choose to either keep, or separate, a bond's interest rate and FX exposures. In addition, carry and

Performance Differs Year-By-Year Across Asset Types

Annual Gross Performance of Select Emerging Market Indices

■ Hard Currency Sovereigns ■ Hard Currency Corporates ■ Local Currency (Hedged) ■ EMFX (Local Currency Unhedged)

2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
22.2%	23.0%	10.2%	15.2%	18.1%	5.4%	34.9%	15.7%	7.3%	17.4%	-0.6%	7.4%	1.3%	10.2%	15.2%	0.7%
16.9%	11.6%	7.3%	9.9%	6.2%	-5.2%	29.8%	13.1%	4.5%	16.8%	-4.2%	5.0%	1.2%	9.9%	10.3%	-1.7%
16.2%	10.3%	6.3%	7.2%	5.0%	-12.0%	22.0%	12.2%	2.3%	15.0%	-5.3%	3.1%	-2.2%	9.7%	8.0%	-4.3%
5.5%	7.7%	6.1%	6.5%	3.9%	-15.9%	5.2%	8.6%	-1.8%	8.9%	-9.0%	-5.7%	-14.9%	4.7%	4.6%	-6.2%

Past performance is not a guarantee or a reliable indicator of future results. *The value of investments can go down as well as up. Where overseas investments are held the rate of currency exchange may cause the value of investments to fluctuate. If applicable, investments in EM are by their nature higher risk and potentially more volatile than those inherent in some established markets and non-USD securities are converted to USD using a spot rate conversion. All periods longer than one year are annualized. Source: JP Morgan. As of 31/12/2018. Information has been obtained from sources believed to be reliable but J.P. Morgan does not warrant its completeness or accuracy. The Index is used with permission. The Index may not be copied, used, or distributed without J.P. Morgan's prior written approval. Copyright 2019, J.P. Morgan Chase & Co. All rights reserved. Hard currency sovereigns represents the JPM EMBI Global Diversified Index. Hard Currency Corporates represents the JP Morgan CEMBI Broad Diversified Index. Local Currency (Hedged) represents the JPM GBI-EM Global Diversified Index (USD Hedged). EM FX represents the JPM GBI-EM Global Diversified Index (Unhedged in USD). An investment cannot be made directly in an index.*

[1] *Source: PGIM Fixed Income as of 31 March 2019.*

rolldown effects can often offset any negative impact from EM currency exposure over the medium term.

• **EM currencies** are influenced to a large degree by the economic growth differential between emerging markets and developed markets. When the growth differential narrows, EMFX often drifts lower. And when it widens, EMFX often shifts higher. During periods of fluctuating growth diffferentials, such as 2016 to 2018, EMFX values tend to fluctuate as well. Regardless of the differential, uneven economic cycles and monetary dynamics frequently present relative value opportunities. Also, when the U.S. dollar is strong and commodity prices are weak, EMFX can be used to cross-hedge credit and interest rate exposures.

Why should investors consider a 'go-anywhere' EMD strategy?
Unconstrained by a benchmark, this strategy allows active managers to focus solely on their most attractive EMD ideas – across hard currency sovereigns, quasi-sovereigns, and corporate bonds, as well as local bonds and currencies – and provides the flexibility to reallocate within this universe as market conditions change. A key feature is that the strategy seeks to deliver attractive risk-adjusted returns instead of alpha over an EMD index. As such, it can provide alpha-generating opportunities while limiting market beta.

Importantly, the strategy allows managers to target specific market segments and maturity ranges and to tactically avoid undesirable issuers that might have a high benchmark concentration. For example, in managing these strategies, we primarily focus on 5- to 7-year maturities where our analysis has found superior risk-adjusted returns across both hard currency and local currency debt. Given this maturity focus, we expect less volatility and higher Sharpe ratios vs. pure hard currency and local currency strategies.

How do you manage an EMD 'go-anywhere' strategy?
All of our EMD strategies, including our 'go-anywhere' Emerging Markets Total Return Bond strategy, are managed within a disciplined framework with clearly defined approaches, security universes, risk budgets, and internal risk thresholds for different types of systematic and tail risks.

Our investment process is both top down with established macro views and bottom up with a focus more heavily on country and individual security selection as sources of return, rather than duration positioning. That said, we do formulate interest rate views for each EM country, which guide our respective positioning and security selection.

Identifying and capturing relative value is the center of our approach. Macroeconomic, country, and individual security research, as well as quantitative analysis and modelling, are employed to uncover market inefficiencies and undervalued and overvalued securities.

What are the drawbacks?
Like any investment, 'go-anywhere' EMD strategies may have a negative return in 'risk-off' markets. In strong risk-off markets, all EMD sectors may have higher correlations, but we would expect the 'go-anywhere' strategy to be less negative than a typical EMD hard currency portfolio. Alternatively, in strong risk-on markets, these strategies may not capture all of the upside. It's a trade-off that depends on the end investor's objectives.

What are your best debt ideas today?
Our emerging markets debt team still holds a 'risk-on' mindset from a medium-term perspective given select valuations. But we have also taken some chips off of the table following the sector's solid returns through the first quarter of this year. In hard currency bonds, we are balancing higher-spread sovereigns and quasi-sovereigns with higher-quality bonds. We are looking for opportunities along both flat and steep yield curves and are employing select credit rating upgrade trades for a minimal give-up in yield. We are finding attractive value in select Latin American, Asian, and frontier countries.

We also favour select local bonds, primarily in countries where we believe excessive interest rate hikes have been priced into the market, and the yield curve is poised to flatten. In EMFX, we are focused on relative value versus directional calls. Regionally, we are long currencies in Asia, short in CEEMEA, and selectively long in Latin America. Across all sectors, we are looking to take advantage of mispriced securities resulting from idiosyncratic, macroeconomic, trade-related, and election/political volatility.

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