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Emerging-market debt focus:

New opportunities

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Beyond the benchmark

The advantages of an unconstrained approach to emerging market debt investing

Introduction

In recent years, the growth in emerging-market debt (EMD) benchmarks has made this asset class more accessible to investors and has increased awareness of a larger and more diverse opportunity set offering new risk factors in currency exposure, local rates and corporate credit. Conversely, it has also added to the complexity of decision making in terms of investment strategy, governance, execution, operational issues and cost.

In our view, although benchmarks can be useful from a fiduciary perspective (eg to monitor manager performance), indices should not be used as a sole reference point for determining an investment approach to this asset class.

There are a number of reasons why. For starters, indices do not represent the true opportunity set, which is much larger than what they include. As such, index-based approaches tend to diminish the diversification benefits of investing in EMD. And these approaches are likely to exclude the best risk-adjusted opportunities as they typically include exposure to parts of the index that are relatively less attractive.

There are also considerable disparities in investment opportunities within the EMD universe at any given point in time; disparities that argue in favour of a surgical approach to this asset class. If one looks at EM bonds in terms of their component risk factors – currency, interest rates, sovereign credit spreads and corporate credit spreads – they will see substantial differences across countries.

Limiting the investment scope of a portfolio manager to a benchmark index, or a small deviation from its constituents, could hamper portfolio returns over time. The portfolio will be unable, or less able, to capture attractive off-benchmark opportunities and may also be at risk of having to hold meaningful positions in markets and securities whose fundamentals or relative valuations are deteriorating.

Allocating to EM debt: The status quo

Currently, what we see is that institutional investors that allocate to EMD typically do so with reference to the composition of one or more indices. The key indices are the J.P. Morgan EMBI Global Diversified Index (EMBI) for sovereign hard currency bonds, the J.P. Morgan Government Bond Index-Emerging Markets (GBI-EM) for local currency bonds and the J.P. Morgan Corporate Emerging Markets Bond Index Broad Diversified (CEMBI) for hard currency corporate bonds.

Mandates are usually either passive, or a variant on passive (eg rebalancing index exposures according to an a priori allocation decision) or 'constrained active', where an active manager's ability to deviate from a benchmark is limited (eg by narrow tracking error limits and limited flexibility to allocate to off-benchmark issues).

The growing appeal of blended allocations

As awareness of EMD's wide opportunity set continues to grow, so, too, does the appeal of a blended approach to the asset class. A blended approach can incorporate hard currency sovereign exposures with positions in local currency, corporate and frontier-market debt. In principle, such an approach could deliver attractive diversification benefits and risk-adjusted returns over time, which are relatively better.

Notwithstanding the above-mentioned variations, the common feature of most blended approaches today is their embodiment of a big-picture, top-down allocation approach. In our view, a top-down blended approach is well suited to investors who want to capture a much broader opportunity set.

From a fiduciary standpoint, a top-down, index-based blend can be seen as conservative. However, from an investment standpoint it also has several drawbacks:

- Allocation reviews usually occur only once a year by a pension board. In reality, decisions made annually at a board level do not match the speed at which investment conditions and relative valuations change within this asset class.

- Blending key EMD asset classes via a top-down approach typically entails a focus on key indices with the result that, even allowing for tactical overweights or underweights, underlying allocations share these indices' inherent limitations.

Allocating across index-like investments also raises other issues. Consider the following:

- Country risk factors are major drivers of EMD asset performance. Unfortunately, country representation across the popular indices varies greatly. For example, India is in the CEMBI, but not in the local index. Allocation across asset types affects country positioning.

- Switching index-like exposures entails meaningful shifts in duration. GBI–EM has a duration of around five years, while EMBI has around seven years. Switches between external sovereigns and external corporates (assuming index-like exposures) will result in a change in US duration. Few investors are fully aware of the extent of developed-market risk within EM indices; a bottom-up risk factor approach, however, would be mindful of this.

- When a country (eg, Russia) is prominent in all three indices, the absolute risk concentration may not be optimal when weightings are combined. Institutional investors also run the risk that submanagers may all overweight the same country. Further, there are often important relative value distinctions between EMD sub asset classes, which fall outside the scope of purely top-down asset allocation.

The advantages of an unconstrained approach for EMD investing

Unconstrained investing offers access to a much broader range of investment opportunities. At Eaton Vance, we prefer an index-unconstrained approach that focuses on country-level macroeconomic and political research across the entire investment opportunity set along with bottom-up analysis of specific risk factors. Bonds can be broken down into their component risk factors: currency, interest rates, sovereign credit spreads and corporate credit spreads. Disaggregating and evaluating such idiosyncratic risk factors at the country level is, we believe, an approach that can be a consistent source of alpha.

Investment management of an unconstrained, blended mandate is a demanding undertaking. It requires extensive investment research resources, a robust operational infrastructure, a dedicated EMD trading capability and strong risk management.

Admittedly, successful management in this asset class requires rather unique skills. Investors considering internal management of their EMD allocation should be aware of these, as well as the fact that internally run strategies can potentially raise governance challenges around transparency and investment performance.

There are also considerations to bear in mind for local currency debt investing. Matching or surpassing the performance of the local currency indices has proved difficult for many investors, particularly in up markets. The J.P. Morgan GBI-EM Global Diversified Index is a gross index – it doesn't reflect the drag on returns of taxes paid by real-world investors who want to track its performance. These taxes will be different for different investors depending on factors such as how the strategy is structured, which instruments are used to execute a trade and where the strategy is domiciled. Investors might want to re-evaluate the cost benefit of how they have traditionally approached local currency debt versus an 'optimised' unconstrained approach.

Clearly, institutional investors will need to do their own due diligence on whether they believe an unconstrained approach can add value. That said, we believe Eaton Vance's track record in unconstrained mandates points to the viability of such an approach. Our Emerging Market Debt Opportunities Strategy, which has been running for more than three years, has been able to generate alpha and excess return with lower-than-benchmark volatility. Counter intuitive as it may seem, a more flexible approach has the potential to offer both better returns and lower volatility.

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Summary
- Local currency EMD declined sharply in 2018.
- There is a wide dispersion within the asset class and no evidence of contagion.
- Currency risk is a major component.
- EMD benchmarks do not capture the opportunity set.

Emerging opportunities

EMD endured a sharp correction in 2018, despite no evidence of economic contagion, finds Alastair O'Dell

Emerging-market debt (EMD) has had a torrid time since April, with sharp declines in value and broad-based outflows. While EM assets are expected to be volatile, local currency EMD has been one of the worst performing fixed income asset classes year-to-date.

"There has been a lot of talk about a 'crisis' – but I would label it a sell-off," says Insight Investment portfolio manager Oliver Williams. The main factor has been the rising US dollar, compounded by an escalating trade war, disappointing EU and Chinese growth and country-specific issues.

The rising dollar must be considered in context. "In 2017 the euro rallied 14 per cent against the dollar – more than EM currencies fell against the dollar this year," notes Ashmore, head of research, Jan Dehn. "EM local currency bonds made about a 25 per cent return in dollars in 2016 and 2017. They were very strong years – so bit of pullback was reasonable."

In 2018 US Fed embarked on a steeper than expected rate-raising path, in tandem with the effects of a large late-cycle fiscal stimulus, strengthening the dollar. The impact on other economies depends on two factors: its fiscal deficit and its current account deficit.

Charles Stanley investment strategist, Kamil Amin, says: "When you see dollar liquidity dry up, economies that have exposure to external debt or negative current account imbalances tend to be impacted first. We should not be surprised, although the magnitude may have been extended by political issues."

Diversification

EMD is one of the least homogeneous asset classes, with huge country-level dispersal. Turkey and Argentina, with twin-deficits, have found themselves in the crosshairs while Mexico and Colombia were unaffected.

"Turkey is the poster child," says SEI investment management unit, portfolio manager, James Mashiter. "It has a structural current account deficit, low FX reserves, high levels of private sector debt and the authorities did not respond with orthodox policies (until mid-September)."

Even orthodox policy measures and heavy IMF involvement were not enough to save Argentina from yet another economic crisis (inflation is 34.4 per cent) and political chaos.

"There have been a handful of fundamental issues in some of the big EM countries," says Eaton Vance global income team, institutional portfolio manager, Brad Godfrey, also noting the sanctions on Russia, Brazil's election and South Africa's recession. "But it has been in some of the bigger ones, big benchmark constituents, which has fuelled the flames."

Dehn adds: "With 70 readily-investible countries we have two or three countries that screw up every year. That's perfectly normal. When there is a positive sentiment, events – such as Venezuela's default in 2017 – are viewed as idiosyncratic. When there is negative overall sentiment people worry about contagion. As an investor you have to look through that."

Contagion

Economic contagion is serious and potentially possible – transmitted via the financial system – while indiscriminate selling on sentiment just provides easy pickings for active managers.

"There is 0 per cent chance that the issues in Argentina and Turkey are going to emerge in a broad based fashion across EM," says Dehn. "They really stand out – they have been running bad macroeconomic policy for the last 10 years and, without domestic pension funds, cannot fund themselves."

Mashiter says it can be considered "sentiment contagion". "As EM funds do not just contain Turkey and Argentina other countries get hit by outflows. And, EM currencies have been the escape valve for imbalances."

Since the global financial crisis, ultra-loose monetary policy pushed investors towards risk in search of yield. "There has probably been a clearing out of positions as investors normalise to their mandates," Amin says. "Having had a decade of good returns, investors have been very quick to sell."

Williams adds: “In early August extreme volatility in the Turkish lira spooked investors into indiscriminate selling. We try to take advantage of those sell-offs, where things have gone too far.”

Turning point

Investors may already be returning to EMD but the evidence is not definitive. The asset class saw the biggest inflows in six months during the week of 19-26 September, according to Bank of America Merrill Lynch.

Godfrey says he has seen slight inflows and interest from European institutional investors. “We are not there yet and we are never going to get that call right – so we don’t spend a lot of time on it,” he says. Dehn has more confidence: “We have certainly seen rising interest and the markets have begun to turn.”

The overriding concern is an acceleration of US rate tightening, making hard currency debts unaffordable. A hard currency debt spiral caused the Asian Financial Crisis in 1997 but, as Godfrey says: “We’re certainly not there yet, and I don’t think we’ll get there,” noting that the prevalence of heavy currency pegs at the time is now absent.

The escalating trade war between the US and China will undoubtedly hit the latter’s export-focused economy. Punitive tariffs were implemented on 1 October, taxing half its exports to the US, and further escalation is certainly possible with mid-term elections on the horizon.

“Tariffs are unambiguously dollar-positive – they are a tax on a section of imported goods so fewer dollars will flow to China,” says Dehn. “But unless there is a further escalation, it has been fully priced. Once we are past the mid-terms, the reality of the 2020 presidential election and the absolute necessity of avoiding a recession becomes paramount, so Trump will find it very difficult to push through draconian protectionist measures.”

China unleashed a huge fiscal stimulus after the global financial crisis – but in 2007 it enjoyed a 10 per cent current account surplus. In the first quarter of 2018 it posted a rare deficit. “Although the authorities have a grip on deleveraging, one of the reactions to the trade war has been a devaluation of the yuan – and that tends to have a big impact on EM sentiment and flow,” says Amin.

Benchmark

EMD is dominated by actively-managed funds. Charles Stanley, which invests passively in its developed market (DM) fixed income and equities, uses active managers. Amin says: “Our starting point is the lowest cost solution. We only consider active when liquidity is challenged and/or the benchmark does not make sense. For EMD our preference is for active as any active manager’s positioning would be extremely different from the benchmark, for very good reasons.”

Passive funds are most commonly based on the suite of J.P. Morgan GBI-EM Indices, which are concentrated to support the liquidity required by passive funds. The widest index, GBI-EM Broad, contains just 17 countries of the more than 100 investable EMD markets. “Diversification well beyond the benchmark is the right thing to do,” Godfrey says. “There is no sense in ignoring a huge part of the opportunity set.”

Passively investing in market cap weighted bond indicies means concentration in highly indebted countries and companies. “You end up with exposures to economies that are rapidly deteriorating,” says Williams. The active manager notes that a passive fund would have increased exposure to Venezuela as its economy crashed and to Lebanon before its bonds were routed in September.

Passive funds are likely to have a cap on country exposure, perhaps 10 per cent, limiting the problem, and smart beta funds have a more sophisticated approach.

“It’s extraordinarily nuanced and there are tremendous inefficiencies from which to take advantage. The benchmarks are extraordinarily poor representations,” says Godfrey. “We are looking for inefficiencies between the direction of policy and the way the markets are valuing the distinct risk factors.”

The downside of active management is, of course, fees. Amin says his firm’s defined benefit (DB) fiduciary solutions do not currently contain EMD. “You pay close to 1 per cent for an active manager, which is quite significant. We would have to think about the risk-reward skew before allocating to it. We are positive on emerging markets – but today we have preference to equity over debt.”

Technical pressure

While local currencies and rates are attractive on an absolute basis – 95th percentile cheap relative to the past 12 years, according to Godfrey – it does not mean there isn’t further to fall.

“We are not bullish on any area of EM markets right now,” he says. “The reason we are not more constructive is that we are concerned about the potential for more technical pressure from investor outflows, which has essentially been driving assets lower since April.”

The structural arguments for EMs are all still there and the economies are expected to grow around 2 per cent faster than DMs. Yield dispersion, relative to DM, is at its widest point for two years, notes Williams. “There has definitely been dislocations where the yield exceeds the risk premium investors should be looking for. But we are slightly cautious for the next six months.”

Amin, adds: “There comes an inflection point when valuations become so cheap on a relative and absolute basis that it makes outright sense to own the asset class.”

Written by Alastair O’Dell, a freelance journalist