EMD: Yielding success

Summary

- Emerging market debt has the ability to generate alpha but also act as a diversifier in portfolios.
- Opportunities in the asset class have expanded over the past decade.
- It is seen as a good option for pension schemes on de-risking journeys.
- Emerging markets are becoming more switched on to ESG issues but at the moment there is an additional layer of complexity for investors to consider.

In the current low-interest rate environment, emerging market debt is seen as one of the few places investors can still generate attractive returns. Natalie Tuck reports

In a world of very low interest rates, emerging market debt (EMD) is seen by some as one of the few remaining asset classes that can generate worthwhile returns. But its uses are not limited to return-seeking investors, as it is also seen as a great diversifier within portfolios.

EMD is mostly divided into three sub-sectors, which includes hard currency sovereigns, local currency sovereigns and hard currency corporates. Explaining the benefits offered by EMD, Willis Towers Watson credit manager research, Rima Sen, says: "We don't believe there is a single opportunity, but many. These opportunities will vary in their risk and return profiles, correlation with broader markets and environmental, social and governance (ESG) credentials. EMD can offer a number of opportunities for yield pick-up, uncorrelated returns, alpha potential or ESG impact."

Expanding on this, MetLife Investment Management emerging market debt portfolio manager, Scott Moses, says: "On the hard currency side, sovereigns and corporates are an extension of what *[pension funds]* are doing elsewhere in their portfolios. They've proven to be efficient over time and compare well with developed market credit."

However, he says that it is the local currency side that has historically been used as the "true diversifier", something that he still sees done more by European investors than their US counterparts. He adds that pension funds with more comfort for local currency risk look to China as an extra diversifier within portfolios.

When it comes to performance, EMD has demonstrated its ability; a report by State Street Global Advisers (SSGA) stated that the asset class delivered positive returns in the second quarter of 2021, as global economic growth continued to aid emerging market countries. Figures from J.P. Morgan revealed that emerging market local currency debt returned 3.41 per cent in Q2 and on the hard currency side, the result was 3.93 per cent. For emerging market (EM) corporate, the figure was 1.97 per cent.

Opportunities

Over the past decade opportunities in EM corporates have "grown significantly", with it now constituting more than 10 per cent of the global credit market, according to Redington senior vice president, manager research, Christoforos Bikos. "At the same time, it has almost matched the EM sovereign hard currency debt universe in terms of market capitalisation. Hence, looking at both asset classes we can conclude that investment opportunities have broadened significantly in terms of country and issuer names."

Expanding on how EM hard and corporate debt can contribute to a pension fund portfolio, Bikos says schemes can benefit from an allocation to EM corporate debt within a fixed income portfolio as it can help reduce "regional and idiosyncratic risks as well as providing exposure to varying business cycles across regions".

Secor Asset Management CFA

portfolio manager, Anja Needham, sees opportunity in high-yield currency EM corporate sovereigns. "While investment grade spreads have recovered to pre-pandemic tights, high yield spreads remain wide. In our internal assessments, this doesn't appear to be justified by quality migration or worsening fundamentals. In terms of implementing this view, our managers are currently overweight high yield versus investment grade within their portfolios."

Furthermore, Aon senior asset allocation specialist, Lucinda Downing, says that as EM debt has underperformed developed market debt this year, it is less expensive compared to its history than developed debt markets. "Investors *[such as pension funds]* with a medium- to long-term view could consider investing in an actively managed fund which includes EM currency exposure, which is attractively valued currently."

Meeting differing needs

The UK's pension schemes are heterogenous in nature with varying needs but with EMD able to offer both return-seeking and diversification opportunities, it can have a part to play for many schemes.

"It's a massive asset class, and because of that it gives you ways to customise solutions that are less customised than they sound; what I mean by that is if you restrict quality buckets, you can create an asset that has similar characteristics to the investment grade developed world with incremental spread pick-ups. So, for the asset liability matcher, that can be extremely attractive," Moses explains.

Furthermore, Moses says there is a unique attraction for the UK pensions industry specifically, as a number of schemes are transitioning from having a large proportion of their portfolio allocated to risk assets to more liability-driven investing (LDI) or risk-hedged approach.

"It strikes me that emerging market debt is actually one of those few asset classes where, with the same manager, you can actually rotate your portfolio from one to the other. By moving from higher-risk to higher-quality within the same asset class," Moses says.

Bikos also sees a role for hard currency EMD in schemes on a de-risking journey, as the asset class exhibits "low correlation to other credit assets and could also be used as allocation during investors' de-risking process via which they aim to reduce portfolio reliance on equities and yet maintain a decent level of overall return. Finally, the number of markets in the main benchmark indices continues to increase and the diversity of issuers is high".

Furthermore, Downing states that EMD can form part of a pension fund's multi-asset credit (MAC) strategy, which has lower risk than equities so could be considered by pension funds looking to de-risk their portfolios from equity exposure.

"Risk is broadly halved versus equity whilst still providing a higher expected return and lower duration than traditional mandates in developed investment grade bonds. Local EMD exposure provides EM currency exposure at currently attractive valuations too."

A scheme's size may limit the EMD opportunities available, however. Moses says that any sized scheme will be able to have access from a vehicle channel, whereas larger schemes also have more flexibility to own those vehicles within their portfolios.

"Depending on your focus of mandate, if you want something all-encompassing, we've seen pension plans that want a lot of local currency risk, but don't want their name on a local custody account in Nigeria. Because of that, they'll prefer a vehicle channel because effectively the vehicle is the all-encompassing option," he says. "Where you've seen more willingness to do separate accounts is more on the local currency side."

ESG perspective

Regardless of the asset class, ESG considerations are now a key factor on pension funds' minds when investing. From an EMD perspective, Moses says that there "continues to be better data available at the individual issuer level to understand where the sustainable impacts of that investment go".

Moses also believes that emerging markets is one of the markets that is "ripe for transition investing" and that the more capital that requests change, the more change you will get. Bikos, however, says that currently not all ESG factors carry the same weight in EM.

"Governance factors tend to be the most material as they affect the attractiveness of a country's sovereign debt and consequently the spread over which corporate debt trades. Additionally, social factors are also important as they help determine the health of the economy. Hence, investors should understand both the fundamental and ESG framework of their managers and more importantly how the qualitative views are integrated into the investment decision-making process and position sizing."

On this topic, Downing also says that an asset manager's approach to ESG in EMD should be distinct from their approach to DM assets. "There is an additional layer of complexity when considering E, S and G issues for emerging issuers and this often requires a different lens and skill set, eg a separate sovereign ESG process, sovereign engagement and a push for data transparency with EM corporates. Testing this understanding and ensuring ESG is properly integrated is crucial to a strategy's ongoing success."

Written by Natalie Tuck

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