Time to Rethink Emerging Market Debt Mandates?

By Peter Marber, Head of Emerging Markets Investments

"We don't replicate the universe, we seek to improve it. We handpick countries and then seek to optimize the portfolio."

Investors who bought into emerging market fixed income over the past 11 years and stayed the course are probably feeling pretty smug right now.

As the table below shows, emerging market (EM) bonds (as represented by JP Morgan's standard Emerging Markets Debt indices) have considerably outperformed Global and US bonds (excluding high yield) over the long term (as represented by the Barclays Global Aggregate and Aggregate indices)—and even some key equity indices.

While the major EM index returns are impressive compared with those of major developed markets, they are obscured by a structural flaw in EM debt indices: they combine investment grade rated and high yield bonds. Virtually all developed bond benchmarks split these two opportunity sets, but they have been combined historically in most EM indices. The table on the following page disaggregates the high yield and investment grade sets using additional JP Morgan indices, and shows comparable returns relative to US equivalents.

EMERGING MARKETS DEBT ASSET CLASS CATEGORY RISK/RETURN, 2003-2013

FIXED INCOME ASSET CLASS	INDEX	ANNUALIZED RETURNS	ANNUALIZED VOLATILITY	2013 RETURNS	2013 VOLATILITY
EM LOCAL CURRENCY	JPM GBI-EM Global Div	10.2%	12.0%	(9.0)%	11.4%
EM HARD CURRENCY SOVEREIGN DEBT	JPM EMBIG	9.8	9.0	(6.6)	9.0
EM HARD CURRENCY CORPORATE DEBT	JPM CEMBI Broad Div	7.7	8.5	(0.6)	5.6
GLOBAL BONDS	Barclays Global Aggregate	5.2	6.0	(2.6)	4.8
US BONDS	Barclays Aggregate	4.5	3.6	(2.0)	3.2
HIGH YIELD BONDS	Barclays US High Yield	10.3	10.2	7.4	4.8
EQUITY ASSET CLASS	**INDEX**	**ANNUALIZED RETURNS**	**ANNUALIZED VOLATILITY**	**2013 RETURNS**	**2013 VOLATILITY**
EM EQUITY	MSCI EM	15.0%	23.3%	(2.3)%	11.8%
GLOBAL EQUITY	MSCI World	9.7	15.8	27.4	9.2
US EQUITY	S&P 500	9.2	14.4	32.4	8.5

Source: Zephyr. Annualized Returns and Volatility from January 2003-December 2013. JPM GBI-EM Global Div: JP Morgan Global Bond Index Emerging Markets (GBI-EM) Global Diversified. JPM EMBIG: JP Morgan Emerging Markets Bond Index Global. JPM CEMBI Broad Div: JP Morgan Corporate Emerging Markets Bond Index Broad Diversified.

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EXPANDED EMERGING MARKETS DEBT ASSET CLASS CATEGORY RISK/RETURN, 2003-2013

FIXED INCOME ASSET CLASS	INDEX	ANNUALIZED RETURNS	ANNUALIZED VOLATILITY	2013 RETURNS	2013 VOLATILITY
EM CORPORATE DEBT HIGH YIELD	JPM CEMBI Broad Div HY	11.4%	13.7%	1.4%	6.0%
EM SOVEREIGN HY	JPM EMBIG Div HY	11.6	10.7	(0.8)	8.8
50% EM CORPORATE DEBT HY & 50% EM SOVEREIGN HY	JPM CEMBI Broad Div HY; JPM EMBIG Div HY	11.5	11.9	0.3	7.2
EM SOVEREIGN INVESTMENT GRADE	JPM EMBIG Div IG	6.9	7.7	(7.6)	9.3
EM CORPORATE INVESTMENT GRADE	JPM CEMBI Broad Div IG	6.7	7.2	(1.4)	5.5
50% EM CORPORATE DEBT IG & 50% EM SOVEREIGN IG	JPM CEMBI Broad Div IG; JPM EMBIG Div IG	6.8	7.3	(4.6)	7.3
EM LOCAL CURRENCY	JPM GBI-EM Global Div	10.2	12.0	(9.0)	11.4
GLOBAL BONDS	Barclays Global Aggregate	5.2	6.0	(2.6)	4.8
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EQUITY ASSET CLASS	**INDEX**	**ANNUALIZED RETURNS**	**ANNUALIZED VOLATILITY**	**2013 RETURNS**	**2013 VOLATILITY**
EM EQUITY	MSCI EM	15.0%	23.3%	(2.3)%	11.8%
GLOBAL EQUITY	MSCI World	9.7	15.8	27.4	9.2
US EQUITY	S&P 500	9.2	14.4	32.4	8.5

Source: Zephyr. Annualized Returns and Volatility from January 2003-December 2013. JPM CEMBI Broad Div HY: JP Morgan Corporate Emerging Markets Bond Index (CEMBI) High Yield. JPM EMBIG Div HY: JP Morgan Emerging Markets Bond Index Global (EMBIG) Diversified. JPM CEMBI Broad Div IG: JP Morgan CEMBI Broad Diversified Investment Grade. JPM GBI-EM Global Div: JP Morgan Global Bond Index-Emerging Markets (GBI-EM) Global Diversified. ***Past performance is not representative of future results.*** *Indices are unmanaged and are not representative of any investment, product or strategy. It is not possible to invest directly in an index.*

Interestingly, the table notes that over the past 11 calendar years, the EM investment grade and high yield segments respectively offered 230 bps and 120 bps[i] more in returns versus comparable US and European credit equivalents. This seems at odds with general ratings methodology. Why has such an arbitrage existed for so long? And why does EM still offer similar higher yields today?

It's one of the great mysteries of bond investing. Perhaps it's a "xenophobia" discount demanded by investors on emerging market bonds. But investors' perception of excess default risk in emerging markets has not proven to be true during the last 11 years. Perhaps people don't believe the methodology of the ratings companies. However, it's difficult to argue with this historical data, which seem to prove the ratings have been right.

The Problem with Indices

We believe the current make-up of the indices may have something to do with the yield arbitrage. Investment grade investors may have shied away from EM because of a prominent percentage of high yield, but pure high yield investors may have also stayed away because of too many investment grade names. This may have led to inefficient price discovery in the asset class.

Beyond the high yield/investment grade obfuscation, liquidity and other methodology filters may tend to create random EM debt index country weightings, all of which shape investment flows dramatically. And EM debt indices have very different weightings than EM equity indices.

EM credit indices for sovereign and corporates also have relatively long durations—in some cases more than seven years. With narrower spreads and historically low absolute interest rates, investors in long duration indices could get hit by rising rates. Look what happened in the summer of 2013, when the widely followed JP EMBI Global sovereign bond index fell more than 10%.

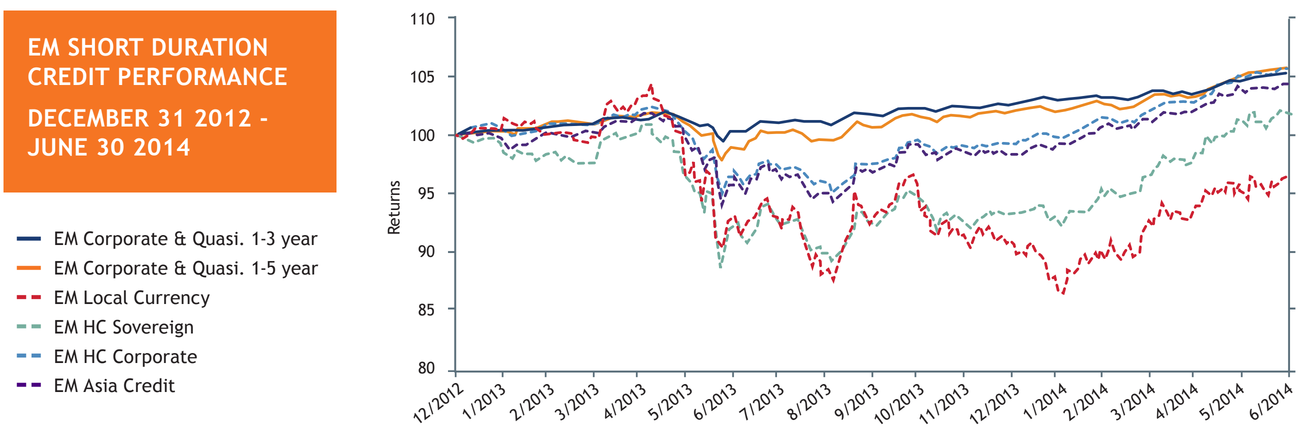
Rethinking the Universe

Investors may need to rethink their approach to EM debt mandates. One solution is to build customized exposure with shorter durations. We've lived through one of the greatest bond rallies ever, and EM bonds have been a huge beneficiary. Since 2003, duration has been a large driver of performance in EM debt with approximately half of the JPM EMBI Global's 9.8% annualized returns coming from the index's US Treasury rate return component. Long duration instruments have benefited from both interest rate and credit spread compression. But this may not continue, and shorter duration EM credit might be an attractive option for bond investors seeking healthy yields.

As the graph below shows in recent years, shorter duration bonds (represented by the solid lines) have experienced lower volatility, while generally providing returns superior to those of longer duration securities.

EM SHORT DURATION CREDIT PERFORMANCE

DECEMBER 31 2012 - JUNE 30 2014



Source: Loomis Sayles, JP Morgan, Merrill Lynch, Barclays and Bloomberg as of June 30, 2014. EM Corp & Quasi 1-3 yr: Merrill Lynch Corp. & Quasi 1-3 yr Index., EM Local Currency: JPM Global Bond Index-Emerging Markets (GBI-EM) Global Diversified, EM HC Corporate: JPM CEMBI Broad Diversified, EM Corp & Quasi 1-5 yr: Barclays EMD USD Corp + Quasi-Sov. 1-5 yr. blend Index, EM HC Sovereign: JPM EMBI Global, EM Asia Credit: JPM Asia Credit.

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The subsequent compression of all credit spreads during quantitative easing has led many traditional bond investors to take more risk to sustain yields, often dipping into lower and lower quality junk bonds. In this environment, EM bonds have still offered decent spreads. We believe that as long as duration is kept low, bond investors can still earn healthy returns in emerging markets, which now include some 70 countries with hundreds of issuers rated from CCC to even AAA. As of July 15, 2014, EM was paying almost 100 bps more in the investment grade space, and 200 bps more in high yield compared with similar rated US and European credit.[ii]

Going forward, we expect duration risk of between one to three years may dampen risk and volatility. Until recently, the market would not have been deep enough to support a strategy based on short-term emerging market sovereign only debt, but issuance—particularly in the corporate arena—has mushroomed since 2010. In the first quarter of 2014 alone, $35 billion of $100 billion in EM issued bonds had maturities of less than 6 years.[iii] The broadening of the EM corporate issuance is likely to be a great opportunity for global bond investors, if they have managers with the right skill sets to exploit them.

Top-Down and Bottom-Up Divergence from the Index

Short duration can be one way of optimizing a portfolio by diverging from traditional benchmarks. Other tools include the top-down as well as the bottom-up selection of names. Whereas currently the emerging markets corporate debt universe comprises around 500 names, we believe that only around 120 are worthy of inclusion in a portfolio. Our thoughts on geographical allocations also differ markedly from the EM short duration universe. For instance, where an index has weightings of about 13% to both Russia and South Korea, we believe a weighting of 3% to 4% is more appropriate. We don't replicate the universe, we seek to improve it. We handpick countries and then seek to optimize a portfolio. We then implement a rigorous stress testing of sectors and names as we try to minimize fat-tail and idiosyncratic risk. That is our mission, to engineer better outcomes for investors than off-the-rack market-cap indices.

Is Emerging Markets Debt the Real Deal?

For many investors, regardless of portfolio construction methodology, the big question is whether the premium on EM debt can persist. In the US, balance sheets have been taking on more leverage. But many EM companies currently have less leverage, stronger fundamentals, and pay more in yield. In the last decade, emerging markets bonds have been something akin to light beer, often cited as having great taste and fewer calories. Similarly, emerging markets bonds have tended to have higher returns with comparable, if not less risk, over the past 11 years.

AUTHOR

PETER MARBER
VP, Head of Emerging Markets Investments

Endnotes

[i] *Represents the difference between the 50/50 CEMBI Broad Div/EMBI Global Div IG and Barclays Aggregate indices and the difference between the 50/50 CEMBI Broad Div/EMBI Global Div HY and Barclays US High Yield indices.*

[ii] *Source: Ratings derived from Moody's and S&P. Spread compression from January 1, 2008-July 15, 2014.*

[iii] *Source: Bloomberg and JPMorgan data, as of March 31, 2014.*

Disclosure

Past performance is no guarantee of future results.

Foreign investments involve greater risks than U.S. investments, including political and economic risks and the risk of currency fluctuations, all of which may be magnified in emerging markets.

Indexes are unmanaged and do not incur fees. It is not possible to invest directly in an index.

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