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Market & Investment Insights

Emerging Market Debt: An Asset Class Grows Up

Katherine Renfrew, Portfolio Manager for the Emerging Market Debt Fund

Investors of a certain age will remember when emerging markets lurched from one economic crisis to the next almost without pause. In 1982, Mexico announced it would no longer make interest payments on its debt and called for a restructuring. Brazil and Chile followed suit soon afterwards. That touched off "the lost decade" for many Latin American countries, which like Mexico were laboring under massive debt burdens and stagnant economies. Inflation rates spiked above 100% in some countries, and economic growth slowed to a crawl.

In 1997, it was Asia's turn. Thailand was forced to float its currency, the baht, when it could not keep up with debt payments. As the baht fell, confidence in the region's other developing economies began to plummet. Many nations fell into deep recessions and local currencies fell to record lows.

Much has changed since then. Emerging market indebtedness has plunged, and many emerging market countries now boast debt-to-gross domestic product ratios that are lower than that of the U.S. Economic growth has returned, political stability has increased, financial markets have matured, and money has poured into countries once viewed as far too risky for private investors.

Today, emerging market debt is one of the best performing asset classes. From 1999 to 2013, emerging market debt delivered stronger returns than developed world investment grade debt, high yield debt, and even domestic and developed international stocks. With interest rates in Europe, Japan, and the U.S. still near record lows, investor interest in emerging market debt – with its higher yields – is on the upswing.

In this Q&A, **Katherine Renfrew, Portfolio Manager for the Emerging Market Debt Fund**, talks about the development of emerging market debt as an asset class and how she manages the fund.

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Asset Class returns and volatility (1999-2013)

	Average Annual Return	Annual Volatility	Sharpe Ratio
Large Cap Stocks	6.21%	15.72%	0.35
Mid Cap Stocks	10.44%	17.73%	0.55
Small Cap Stocks	10.25%	20.60%	0.47
International Stocks	3.64%	17.58%	0.17
Emerging Market Stocks	10.92%	23.57%	0.44
Investment Grade Bonds	5.17%	3.54%	1.27
Short Term Bonds	3.56%	1.52%	1.91
Emerging Market Bonds	10.91%	10.41%	0.98
High Yield Bonds	7.74%	10.00%	0.71

Source: Bloomberg Large-cap stocks represented by the Russell 1000 index. Investment-grade bonds represented by the Barclays U.S. Aggregate Index. Mid-cap stocks represented by the Russell Mid-Cap Index. Small-cap stocks represented by the Russell 2000 Index. Non-U.S. stocks represented by the MSCI-EAFE Index. Emerging-market stocks represented by the MSCI Emerging Market Index. Short-term bonds represented by the Barclays U.S. Government/Credit 1–3 Year Index. Emerging-market bonds represented by the JPM EMBI Plus Index. High-yield bonds represented by the Barclays U.S. Corporate High-Yield Index. Annual returns, volatility, and Sharpe ratios reflect performance for the period of 1999–2013. It is not possible to invest in an index. Performance for indices does not reflect investment fees or transaction costs.

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1) *What makes Emerging Market debt attractive as an asset class?*

Emerging market debt has benefited greatly from the faster long-term growth rates these economies have achieved compared with developed markets. In addition, favorable demographic profiles for some large emerging markets such as India, Brazil, Mexico, Turkey and South Africa as well as improving monetary policies, stronger macroeconomic frameworks and accelerated infrastructure development have also helped boost investor confidence in emerging market debt. These markets are much more conducive to investment than they were 20 years ago.

Also, emerging market debt has delivered returns that are only loosely correlated to debt issued from developed markets, which makes it attractive from a portfolio diversification standpoint. For the 1999-2013 period, emerging market debt — as represented by the JPM EMBI Plus index — had a correlation of 0.46 with domestic investment grade bonds (Barclays U.S. Aggregate Index), 0.60 with U.S. high-yield bonds (Barclays U.S. Corporate High-Yield Index), and 0.11 with domestic short-term bonds (Barclays U.S. Government/Credit 1–3 Year Index). (Correlations of 1 mean that the magnitude and direction of every move in one asset class was the same as that for another asset class. Correlations of zero indicate no relationship in the moves of each group, while a correlation of -1 indicates that every move in one asset class was the exact opposite of the other class.)

2) *What's the investment philosophy behind the Emerging Markets Debt Fund?*

We use a top-down/bottom-up approach to pursue our goal of outperforming our benchmark index. Part of our strategy for outperformance involves buying corporate bonds that are not represented in the benchmark, as well as debt issued in local currencies. Another part of our strategy for outperformance comes from country allocation and selection in the hard currency sovereign and quasi-sovereign benchmark sectors.

We take a "blended" approach to the question of U.S. dollar denominated emerging market debt versus debt issued in local currencies, owning both types of debt in varying proportions depending on market conditions. As lead portfolio manager, I determine how much of the fund's assets are in local currencies at any given time with input from co-Portfolio Manager Anupam Damani and our research team.

Our local currency exposures are chosen carefully, because unhedged foreign exchange exposure is a risk that can wipe out the high yields emerging market debt offers. This decision is influenced by many factors, including economic growth and inflation rates, the current level of nominal and real local interest rates, as well as currency valuations. We also factor in investor and capital flows as well as technical color from our dedicated emerging market traders. So far, we have not hedged our currency exposures and have only tactically added local issues that we believe will outperform dollar opportunities in that country.

3) *Will the fund own debt from both sovereign and corporate issuers? In what proportion?*

While some emerging market debt funds own sovereign debt exclusively, our approach has always considered allocations to corporate debt, taking advantage of our firm-wide expertise in emerging market corporates that goes back decades. Our credit discipline has always been strong and we believe that this gives us a potential competitive advantage over other firms who only started investing in emerging market corporates over the past seven years.

Our investible universe is wide ranging and includes the 100% government-owned (quasi-sovereign) companies that currently make up 25% of our benchmark index, as well as other, out-of-benchmark companies that are partially government owned and out-of-benchmark companies that have no government ownership at all. In every case, we undertake a rigorous fundamental research approach that helps add more context to the overall valuation analysis.

The fund's asset allocation is broken down along four categories: emerging market sovereign debt in U.S. dollars, emerging market sovereign debt in local currencies, emerging market corporate in U.S. dollars, and emerging market corporate debt in local currencies. Our overall allocation as of mid-2014 was 50% sovereigns and 50% corporates, but this is not static. We lowered our allocation to corporates aggressively in 2008 and 2009 though we did not exit entirely, which proved to be beneficial when markets recovered.

4) *How has the market for emerging market debt changed in recent years?*

In 1998, when I started on our emerging market debt team, only 20% of our benchmark index members had an investment grade credit rating. Today, the index is more than 60% investment grade. The improvement in credit quality has allowed many countries to develop their own domestic debt markets. While inflationary pressures still exist, most countries have adopted more robust monetary policies to manage their economic cycles and many have flexible exchange rates that help cushion them from downturns. Corporations are now issuing debt in local markets – a rare event 20 years ago. As a result of their economic progress, the benchmark now has securities from 60 different countries, twice as many as when I started.

5) *What country weightings do you expect the fund to have?*

Country weightings shift frequently based on valuations and our views about which countries and companies will outperform the benchmark. In order to maintain sufficient diversification, it is rare for us to have more than 5% of assets in any one country. In the first quarter of 2014, one of our top-five country overweights relative to the benchmark was Sri Lanka, which was a positive contributor for us. We held sovereign, quasi-sovereign and local currency exposure to Sri Lanka.

6) *What risks should investors consider when investing in emerging market debt?*

The smaller, though growing, size of the emerging market U.S. dollar-denominated debt markets makes them more vulnerable to market selloffs. Market liquidity is a bigger issue for corporates, but can be a factor at times for sovereign debt as well. Political risk, credit risk and currency risk all are significant issues and investors need to be aware of those risks. We take a diversified approach and have managed adeptly through many cycles.