Executive summary

- A confluence of factors—rising issuance, a stronger U.S. dollar, and slowing growth in many developing economies—has led to heightened investor concerns about potential systemic risks in emerging market (EM) corporate bonds, a $1.63 trillion asset class.
- While these concerns have valid premises, we believe they are largely overstated, given mitigating factors and compelling asset-class and security-specific characteristics that may be overlooked by investors.
- Within the EM corporate fixed-income universe, overall fundamentals appear sound, issuance generally reflects a financial deepening process as EM economies mature, and the impact of the dollar’s strength will vary across different types of EM issuers.
- Widespread concerns have pushed EM corporate bond valuations down, creating attractive relative value opportunities versus other fixed-income categories.
- In light of the unique nuances of investing in EM corporate bonds, investors seeking to take advantage of the attractive valuations and long-term diversification benefits of this asset class are best served by choosing an active manager with a proven track record supported by deep expertise and resources.

Introduction

Should investors be wary of systemic risk in emerging market corporate fixed-income securities? The amount of corporate debt issued in emerging markets has soared five-fold since 2005, to $1.63 trillion (2014), easily outpacing the growth of all other fixed-income asset classes during the same period. This surge in issuance has been accompanied by heightened concerns about widespread risk in these investments, primarily in three main areas:

- **Potential credit risk.** The rapid pace of issuance has been followed by cooling growth in many emerging market economies, leading some investors to wonder if a market bubble has occurred, particularly among quasi-sovereign issuers (i.e., those for which a national government has 50% equity ownership or 50% voting rights). The worry is that amid weaker economic conditions, especially in several commodity-exporting countries, some issuers may face difficulties meeting debt repayments.
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- **U.S. dollar appreciation.** Significant strengthening of the dollar relative to many EM currencies could hinder the ability of some issuers to pay back debt, especially given the strong growth in foreign currency borrowing by EM firms in recent years.

- **Refinancing worries.** There is a concentration of EM corporate debt maturing over the next few years that will need to be refinanced. The ability of issuers to do this may be hampered in a rising U.S. interest rate environment, which could increase debt service burdens and reduce market appetite to roll over the debt.

While these factors represent areas of concern that warrant attention, our research suggests that they do not pose systemic risks to the asset class. Rather, they offer compelling investment opportunities on a selective basis. Relative to EM sovereign and U.S. corporate debt, current EM corporate and quasi-sovereign bond valuations are largely pricing in these concerns. Thorough, bottom-up analysis of potential currency and refinancing risks on individual issuers’ balance sheets and cash flows is critical to unveiling these opportunities. We rely on our deep EM corporate expertise and collaboration with our sovereign analysts to navigate this environment.

**Risks associated with surge in issuance are mitigated by other factors.**

Growth in emerging market corporate debt has outpaced that of other fixed-income asset classes over the past 10 years (see Figure 2). Since 2005, the aggregate amount of EM corporate external debt issued has risen 381%, surpassing growth in issuance of U.S. leveraged loans (256%) and U.S. Treasuries (196%). Various factors propelled this growth, including the desire and ability of corporations to tap into capital markets given the low interest-rate environment.

Other measures point to rapid growth as well. The number of issuers, for example, has increased significantly. In 2006, there were 145 new issuers accounting for 35% of total issuance. By 2013, a record 184 new issuers accounted for 25% of total issuance amid historically low U.S. interest rates. Recent geopolitical and region-specific developments have moderated the pace of increase over the last 12 months. In addition, the number of countries represented in the JPMorgan Corporate Emerging Markets Bond Index (CEMBI) has more than tripled, from 12 to 41, over the past decade, while the number of issuers in the index has risen nearly nine-fold, from 35 to 315, over the same period.

**Figure 1: EM corporate bonds represent a growing share of the total EM debt market**

![Figure 1](image-url)

Source: JPMorgan. External corporate debt is represented by the JPM CEMBI Broad index plus the quasi-sovereign issuers of the JPM EMBIGD index (total value of $1.2 trillion as of April 20, 2015). External sovereign debt includes the sovereign-only portion of the JPM EMBIGD. Local sovereign debt is represented by the JPM GBI-EMD.
On the surface, this pace of growth may seem unsettling, raising the specter of an asset-class bubble as issuers borrowed at a rapid pace to exploit low interest rates. However, it is important to recognize that two-thirds of EM investment-grade corporate issuance is used for debt refinancing, reflecting an interest in diversifying sources of capital and lowering funding costs—all of which support the overall financial health of the issuers.

It is also important to isolate China’s disproportionate role in driving the recent growth in EM corporate debt. Issuance from China accelerated sharply between 2009 and 2014, from 1% to 31% of total issuance. Excluding China reduces growth in EM corporate issuance during 2005–2014 from 385% to 277%. Moreover, while the pace of growth in China’s external debt warrants monitoring, the country’s total stock of foreign currency debt is estimated at less than 10% of its total outstanding debt. Also, China has ample foreign exchange reserves that it could tap to support issuers. There is risk in China, however, stemming from a significant buildup of domestic credit in the overall economy, particularly from channels outside of the traditional banking sector.

**Figure 2: Growth in emerging market corporate debt has surged in the last decade**

EM corporate bonds: Change in aggregate size versus other asset classes (% growth since YE05)

In most cases, the rise in debt at non-financial corporations in emerging markets reflects “financial deepening”—a natural progression in the scope of services provided by a country’s financial system and degree of financial access by various types of borrowers as the economy matures. As shown in Figures 3 and 4, growth in total non-financial emerging market corporate debt (domestic and external from all sources) has been the main driver of rising indebtedness in these economies, with substantial increases in China, Brazil, and Turkey. Total non-financial EM corporate sector debt stands at 83% of GDP, up from 67% in 2009, but this figure is heavily weighted toward China (125%). For most other large EM countries, the figure is much lower, in the 22% to 65% range. This compares to an average of 97% for 13 advanced economies, which are rated AA on average.
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Non-financial corporate debt is the primary driver of total EM indebtedness.

Furthermore, growth in total EM domestic and external non-financial corporate debt has been offset partially by a decline in government debt. Additionally, a sizable portion of the growth in EM corporate debt is driven by quasi-sovereigns. Figure 5 shows the growth in foreign currency EM debt by type, which includes quasi-sovereign debt.
Figure 5: A sizable portion of EM corporate bonds have been issued by quasi-sovereigns

Outstanding foreign currency bonds by obligor

* Agency is defined as municipal or state debt. Corporate (government backed)/quasi-sovereign is defined as those entities for which a federal government is the ultimate obligor.
Source: Nomura, TIAA-CREF.

Asia and Latin America are driving the overall rise in quasi-sovereign issuance.

Some investors cite accelerated issuance by quasi-sovereign corporations, which has outpaced growth of the broader EM corporate debt market, as a source of concern (see Figure 6). Quasi-sovereign issuance accounted for 39% of total EM corporate issuance in 2005, rising to 49% in 2014. This growth is most pronounced in Latin America and Asia (especially Brazil, Mexico, and China), where quasi-sovereign bond issuance saw compounded annual growth rates of 28% and 25%, respectively, from 2005–2014.

Figure 6: Quasi-sovereign issuance has outpaced growth of broader EM corporate bonds

EM corporate and quasi-sovereign issuance, indexed to 2005

Source: JPMorgan, TIAA-CREF.
The rise in debt issued by Latin American and Asian quasi-sovereigns has resulted in higher financial leverage and growing disparity between quasi-sovereign and corporate credit metrics in these regions (see Figures 7 and 8). In particular, leverage trends at Latin American quasi-sovereign corporations have deteriorated more rapidly in recent years, while Asian credit metrics show signs of stabilization.

Figure 7 & 8: Quasi-sovereign financial leverage metrics in Latin America have deteriorated

Gross debt-to-EBITDA

A closer look at the data for Latin America reveals that the increase in leverage is being driven mostly by Petrobras (the Brazilian oil and gas producer), which currently has $51 billion of external debt outstanding. In 2006, Petrobras discovered the Lula (formerly known as Tupi) oilfield off the coast of Rio de Janeiro, which was estimated to have 8 billion barrels of recoverable oil embedded in its pre-salt layer. Petrobras took on significant amounts of leverage by issuing debt to finance the development of these pre-salt fields. Petrobras’s ambitious capital expenditure plans are currently under evaluation by the company given the decline in global oil prices and a federal investigation of corruption and money laundering allegations. In aggregate, financial leverage in CEEMEA (Central & Eastern Europe, Middle East and Africa) is lower and has risen at a more moderate pace, although some quasi-sovereign issuers, such as in South Africa, have seen a marked increase since 2008.

A closer look at Latin America data reveals the increase in leverage is driven mostly by Petrobras, the Brazilian oil and gas producer, with $51 billion of external debt outstanding.
The impact of the stronger dollar varies significantly across EM issuers.

Investors have been anxious over the sharp appreciation of the U.S. dollar and its broad impact on emerging market debt. Indeed, currencies in several key emerging markets, including Brazil, Colombia, India, Indonesia, Turkey, South Africa, and Russia, have experienced significant depreciation pressure since 2012. We believe that volatility in emerging market currencies is likely to persist amid U.S. monetary policy normalization and weakening growth in some emerging market economies. In addition, some EM currencies may come under pressure because of structural factors and price shifts in commodities, which are correlated closely with EM assets. For example, we estimate that, based on market value, 30% of the issuers in the JPMorgan Emerging Markets Bond Index-Global (EMBIG) – a mostly sovereign index plus 100% owned quasi-sovereigns – rely significantly on oil and gas revenues.

Currency risk, coupled with the increase in EM non-financial corporate debt issued in foreign currency, has raised concerns about potential mismatches between earnings and liabilities of the issuing corporations and their ability to service the debt. However, such mismatches vary greatly across EM corporations, highlighting the need to assess each individual issuer closely to understand the currency composition of its assets, liabilities, and cash flows, rather than assume a uniform impact on the entire asset class.

In our view, currency depreciation is unlikely to create systemic risks in emerging market debt. A number of factors lead us to this assessment:

- First, many issuers are exporters with natural hedges (i.e., the currency composition of their debt and cash flows to service debt are largely matched) or, in some cases, are firms with financial hedges in place, mitigating the potential for losses stemming from currency swings. For borrowers with unhedged currency mismatches, there may be other factors, such as strong liquidity profiles and low leverage positions, which mitigate concerns over their near-term debt repayment capacity.

- Second, monetary authorities in some EM countries have already taken steps to curtail foreign currency borrowing by implementing various policy measures.

- Lastly, we believe that, in many cases, there is a strong willingness and capacity for governments to support strategically important corporate issuers in meeting their liabilities.

The growth of the EM bond market has focused on export-oriented industries, resulting in natural hedges. The sharp fall in commodity prices does exacerbate risks for some of these issuers; however, in many cases, such as Russia, companies have disproportionate costs in local currency, which helps to protect margins when commodity prices decline and local currency depreciates commensurately.

Risk from currency depreciation is more pronounced for issuers with assets and cash flows generated predominantly in local currency and with sizable foreign currency debt outstanding. This risk is particularly acute for Turkey, where central bank statistics suggest that the non-financial corporate sector’s foreign currency liabilities exceed assets by $177.5 billion, or 21% of GDP. However, for many EM companies (including some Turkish corporate issuers), financial hedging, low initial levels of leverage, and/or extended debt maturity profiles may serve to partially mitigate negative impacts of currency depreciation.
Emerging market bank issuers may also seem more vulnerable to currency fluctuations, but the direct impact of currency depreciation is limited. This reflects tighter regulations that many countries implemented after the financial crises of the 1990s and early 2000s, requiring banks to match their currency exposures of assets and liabilities. The main risks from currency depreciation are the erosion of financial strength (as measured by bank capital ratios) due to large foreign currency loan exposures and asset quality deterioration from loans to unhedged borrowers.

As shown in Figure 9, for most large economies in Latin America and Asia, bank exposure to risks stemming from currency swings appears to be fairly contained. Russia and Ukraine, which have both suffered from unprecedented currency devaluation since the end of 2013, have relatively high exposure to currency volatility and have seen bank balance sheets weaken.

Concerns have also been raised about bank exposures to unhedged foreign currency borrowers in Turkey (where 40% of loans to corporations are in foreign currency) as well as in Peru. However, we note that major bank issuers in those countries have fairly strong loan loss reserve requirements and ample capital reserves to weather potential defaults. Regulators are proactively monitoring these risks in both countries. In Peru, foreign currency loans as a percentage of total loans has fallen dramatically from a peak of 75% in 2005 to 50% in 2011 and 37% as of November 2014, thanks to Central Reserve Bank (BCRP) policy measures that have included increasing reserve requirements on foreign currency liabilities periodically over the past five years, and increasing capital requirements on foreign currency loans since 2012. BCRP continues to implement measures to further shore up the financial system, targeting foreign currency residential mortgage and auto loans, where the majority of borrowers earn income in local currency.
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Refinancing risks are manageable.

In the context of possible currency depreciation and rising interest rates going forward, market observers have pointed to potential short-term refinancing risks for EM corporate and bank issuers, given a debt maturity profile concentrated over the next few years, as shown in Figure 10. Although refinancing risks exist in individual cases, we do not see systemic issues related to repayment, as overall debt repayments appear manageable in the near term.

![Figure 10: Debt maturities are concentrated over the next few years, but do not present a systemic risk to the asset class](source: JPMorgan)

Corporations and quasi-sovereign entities in China and Russia hold 32% of the total bonds maturing between 2016 and 2019. Sovereign involvement raises concerns over government intervention in corporate decision-making, but also presents a scenario in which governments can provide support to companies, if necessary. The provision of sovereign support is often opaque and tends to be selective, with a focus on significant, strategically important companies. In China, we believe the government has ample foreign exchange reserves and various policy levers it can use to support key sectors even as the country undergoes a period of economic transition. In Russia, the state still has strong buffers – such as a positive net international investment position and substantial foreign exchange reserves – to lend support to strategically important corporations if needed. In addition, Russia's central bank has taken steps to help corporations refinance their external liabilities and smooth the deleveraging process by injecting foreign exchange liquidity into the market. Overall, many EM governments have improved their external positions over the past decade, leaving their economies with sufficient foreign exchange resources to meet near-term liabilities for the corporate sector.

On the corporate side, while gross debt has risen in recent years, many companies have built up their cash balances. Recently, we have seen signs of capital expenditure reductions, especially among some commodity producers in response to lower prices, as corporations conserve cash amid a slower growth environment.
Attractive valuations offer select investment opportunities.

In many cases, current valuations are largely pricing in concerns about currency exposure and rising debt, creating pockets of opportunity for astute investors. In the current environment, a bottom-up analysis of currency and refinancing risks for issuers’ balance sheets and cash flows is critical to unveil the best investment opportunities among EM corporate bonds.

Credit selection and analysis are particularly important for quasi-sovereigns, where evaluating their fundamental credit profiles and degree of expected government support is critical for differentiating between comparable issuers. One key valuation metric is the spread difference between a quasi-sovereign issuer and the sovereign issuer. This spread moves with changes in assumptions related to shareholder support and financial policies, among other reasons. Fluctuations in this metric can provide compelling investing opportunities, although identifying those opportunities is often challenging. A common method is to look at the differential between large benchmark indices, such as JPMorgan’s CEMBI Diversified (corporate and less than 100% government-owned quasi-sovereigns) and EMBI Global Diversified (sovereign and 100% government-owned quasi-sovereigns only). However, because there are significant differences in the constituents of these indices, comparisons between the two can be misleading.

For example, Figure 11 suggests that EM corporates are very rich compared with sovereign credit, actually more expensive than their sovereign counterparts. Figure 12 highlights some key differences between the indices that explain at least part of this phenomenon. The CEMBI Diversified has a lower average duration and a one-notch-higher average rating, which tends to imply lower spreads. Additionally, Asia, the region with the lowest average spread, has a proportionally larger contribution to the total market capitalization of the index, while CEEMEA and Latin America (with average Treasury spread to worst around 150 basis points wider than Asia as of April 10, 2015) are underrepresented. At the country level, very highly rated countries such as Hong Kong, United Arab Emirates, and South Korea are significant contributors to the CEMBI but have no presence in the EMBI. In contrast, below-investment-grade and split-rated countries such as Hungary, Lebanon, and Indonesia have substantially greater representation in the EMBI than the CEMBI.
### Figure 12: Key differences between the CEMBI diversified and EMBIGD

**As of 4/10/2015**

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<thead>
<tr>
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<th>CEMBI Div</th>
<th>EMBIGD</th>
<th>CEMBI Div-EMBIGD</th>
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<tr>
<td><strong>EIR duration</strong></td>
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<td><strong>Regional distribution (Mkt Cap %)</strong></td>
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<td>CEEMEA</td>
<td>33.0</td>
<td>43.9</td>
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<td>29.7</td>
<td>36.5</td>
<td>-6.8</td>
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<tr>
<td><strong>Country distribution (Mkt Cap %)</strong></td>
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<tr>
<td>CEMBI Div &gt; EMBIGD</td>
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<td></td>
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<tr>
<td>Hong Kong</td>
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<tr>
<td>India</td>
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<td>0.6</td>
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<tr>
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</tr>
<tr>
<td>Israel</td>
<td>3.9</td>
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<tr>
<td>EMBIGD &gt; CEMBI Div</td>
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<tr>
<td>Philippines</td>
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<td>4.8</td>
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<td>Hungary</td>
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<td>-2.5</td>
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In summary, to draw cleaner relative value conclusions, it is important to compare each corporate security to its respective sovereign counterpart, adjusting for differences between the underlying securities. As implemented by JPMorgan (see Exhibit 13), this methodology paints a very different picture of relative value than that shown in Exhibit 11, suggesting that corporates and quasi-sovereign securities, on average, both trade more than 150 basis points apart from their respective sovereigns. Also noteworthy is that current levels are above the average calculated over the period from January 2012 to present and are near or above the levels seen during the “taper tantrum” in spring 2013.
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Figure 13: Relative value is more evident when adjusting for differences among underlying securities

EM corporate and quasi spread to sovereign (maturity and constituent-adjusted)

<table>
<thead>
<tr>
<th>Category</th>
<th>Spread</th>
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<tbody>
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<td>All corps (ex quasis)</td>
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</tr>
<tr>
<td>All quasis</td>
<td>131</td>
</tr>
<tr>
<td>EMBIG quasis (100% govt-owned or guaranteed)</td>
<td></td>
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</tbody>
</table>

Source: JPMorgan.

In considering a global investor’s opportunity set, it may be more relevant to compare EM corporate bonds to their U.S. or global counterparts. Figure 14 shows that, excluding Russia, the current spread in investment-grade EM corporate bonds compared with investment-grade U.S. corporate bonds is close to the average of 79 basis points in the period since January 2012. There are, however, significant regional differences, as shown in Figure 15. Spreads between investment-grade corporate bonds in Latin America and the U.S. have generally widened and are above the overall average. In contrast, the Middle East and Asia have become relatively more expensive over the time period, although they still offer investors some compensation for the level of risk assumed.

Meanwhile, there has been a significant drop in CEEA (Central & Eastern Europe and Africa) spreads compared to U.S. securities since the end of March 2015, as many Russian issues fell out of the data set following Russia’s downgrade to below-investment-grade status. Similarly, Brazil’s Petrobras was also downgraded by Moody’s to below investment grade around the same time. Even without Russia and Brazil, spreads in these regions compared with the U.S. remain relatively attractive compared to recent history.
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Figure 14: Investment-grade corporates bond: Current EM spread (ex-Russia) vs. U.S. is close to three-year average...

EM IG spread to US IG: Aggregate differential and aggregate ex-Russia

Source: JPMorgan. The underlying data consists of investment-grade emerging market corporate bonds, chosen by JPMorgan, which mirror the EM constituents of the High Grade US Liquid Index (JULI), including some quasi-sovereigns that are not 100% government-owned. The spreads are aggregated and averaged by region based on market-value weights.

Figure 15: ...with wide differences among underlying regions

EM IG spread to US IG: Differentiation by region

Source: JPMorgan. The underlying data consists of investment-grade emerging market corporate bonds, chosen by JPMorgan, which mirror the EM constituents of the High Grade US Liquid Index (JULI), including some quasi-sovereigns that are not 100% government-owned. The spreads are aggregated and averaged by region based on market-value weights.
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Conclusion
While recent concerns about emerging market corporate bonds have merit, we believe they are largely overstated, given mitigating factors and compelling asset-class and security-specific characteristics that may be overlooked by investors.

Within the EM corporate fixed-income universe, overall fundamentals appear sound, issuance generally reflects financial deepening, and the potentially negative impact of the dollar’s strength varies considerably across issuers. Meanwhile, the rise in debt from quasi-sovereign issuers, has been concentrated in Asia and Latin America, and refinancing risks appear manageable. On balance, these considerations, combined with attractive valuations, bolster the case for careful and strategic investing in emerging market corporate debt as part of a diversified long-term portfolio.

In light of the unique nuances of investing in EM corporate bonds, investors seeking to benefit from exposure to this asset class will be best served by choosing an active manager with a proven track record supported by deep expertise and resources.

Learn more about TIAA-CREF’s investment capabilities in emerging markets debt:
Visit us at www.tiaa-cref.org/assetmanagement.

1 “Financial deepening” refers to a natural progression in the scope of services provided by a country’s financial system and degree of financial access by various types of borrowers as the economy matures.
2 Based on JPMorgan estimate, which includes CEMBI Broad constituents, EMBIG-eligible 100% state-owned quasi-sovereigns, and non-index-eligible bonds (e.g., non-USD, structured credit, and 100% state-owned quasi-sovereigns which are not eligible for EMBIG inclusion).
3 All sources include domestic and cross-border bank debt, local capital market issuance, and external debt.
4 Based on McKinsey Global Institute estimates. Advanced economies include Australia, Belgium, Canada, Denmark, Germany, Ireland, Italy, Japan, Netherlands, Spain, Sweden, United Kingdom, and the United States.
5 “Treasury spread to worst” refers to the bond spread over U.S. Treasury bonds of similar maturity, using the lowest yield of the bond taking into account call, put, exchange, and other features.

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Fixed-income investments are subject to market, interest-rate, and credit risks. The risks associated with foreign investments are often magnified in emerging markets where there is greater potential for political, currency, and economic volatility. Securities issued in emerging market nations may be less liquid than those issued in more developed countries.

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