RBC Global Asset Management

Freeing the potential of emerging market bonds

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> **"An unconstrained strategy can help capture the upsides while dampening volatility."**

Emerging market (EM) debt has a reputation for risk and volatility, but this crude characterisation ignores the huge diversity within the asset class and its potential for attractive returns and controlled risk. An unconstrained strategy can help capture the upsides while dampening volatility.

EM debt is not a homogenous asset class. It encompasses a vast range of assets – from Chinese corporate debt to Turkish sovereign bonds. The local currency universe of EM debt is valued at more than US$21 trillion, across 75 countries and 40 investible currencies.

With such a diversity of assets, regarding EM bonds as a single class with a broadly common risk and return profile is too crude. It completely misses the remarkable opportunity for unlocking returns through skilled asset selection, as well as the potential for significant diversification.

We believe the general outlook for EM for 2024 is positive. In many markets, central banks have firmly constrained inflation while allowing economic growth to get underway. While this is welcome and provides one reason to consider EM bonds, the key to an unconstrained strategy is not this broad positive outlook, but the opportunity for a more sophisticated and dynamic approach.

The EM universe includes disparate markets such as Egypt and South Korea. Meanwhile, the current outlook for interest rates and economic growth is not the same for Brazil as it is for Malaysia; corporate debt in Ukraine does not have the same risk-return profile as Columbia; and the US elections this year will not impact the dollar exchange rate with the Chinese Yuan in the same way as the Turkish Lira.

The objective of an unconstrained strategy, such as that applied by the BlueBay Emerging Market Unconstrained Bond Strategy, is to take advantage of this opportunity to diversify, judiciously allocating investments to undervalued assets and avoiding volatility traps.

The key pillars to an unconstrained strategy are flexibility, high conviction, systematic hedging and an alertness to idiosyncratic situations that can deliver high returns.

Our strategy, for example, can invest 100% in local currency, 100% in hard currency and anywhere in between, allowing the fund to flex in a way that reduces exposure to FX risk between local currencies and the US dollar. Meanwhile, being free from benchmark targets an unconstrained investment strategy can eschew bonds when the future upside is likely to be poor, even if those assets are highly weighted in global EM bond indices.

Indeed, much of the apparent volatility in EM debt stems from such benchmarks – which, by their nature, tend to be concentrated in a narrow range of sectors, currencies and economies. This can be clearly seen in the performance of the BlueBay Emerging Market Unconstrained Bond Strategy, which even in the highly challenging year of 2022 returned -7.36%, compared to -14.74% in the reference blended index.[1] In 2023, the fund delivered double-digit returns.

An unconstrained approach cannot eliminate the volatility of EM, making it unsuitable for investors with short-term investment horizons, but, over the longer term the selective tactical capabilities of an unconstrained strategy can be a valuable addition to a diversified portfolio, capturing the attractive yields of EM debt while not succumbing to the risk and volatility of constrained strategies.

[1] JPMorgan RBC GAM, as at December 2022.

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