RBC Global Asset Management

Ways to access emerging market debt

Emerging markets team

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We introduce a framework to help investors consider the most suitable way to access EMD including benchmark relative and several benchmark agnostic strategies, including unconstrained, absolute return (long/short) and private credit.

> "Active funds can also benefit from a larger investable universe with the option of investing in off-benchmark positions."

Passive investment in EMD is sub-optimal and investors should tread carefully

EMD markets can, at times, be significantly inefficient and volatile with meaningful dispersion between the best and worst performing bonds. Passive investors could therefore be tied into highly volatile returns. In contrast, active investors are in a position to avoid the potential pitfalls associated with deteriorating credit developments and can employ downside protection strategies to mitigate negative periods in the market, allowing for a attractive risk-return profile.

Active funds can also benefit from a larger investable universe with the option of investing in off-benchmark positions. These may include bonds that lie outside the index yet offer higher risk-adjusted return potential, or bonds issued by smaller issuers that the index might not capture due to liquidity or other constraints defined by the index provider.

This is particularly relevant in the EM local currency market, which accounts for approximately 80% of the global EM debt universe[1], yet the key indices only represent about 20% of the investable local market universe. This means the benchmark is highly concentrated amongst the high beta local currency markets and can be very volatile and not necessarily a true reflection of the overall sub-asset class. As a result, passive investors miss a vast opportunity to diversify outside of the benchmark and potentially boost returns.

[1] RBC Global Asset Management as of December 31, 2024.

A framework to help identify the most suitable active approach

Below, we introduce a framework to help investors consider the most suitable way to access EMD, based on their requirements with respect to benchmark, liquidity, flexibility regarding asset class exposure and yield. We illustrate this spectrum in Figure 1, using the strategies we offer to our clients as examples.

Benchmark relative

- **Asset class focus:** Investors who aim to gain exposure to the beta of a specific sub-asset class (e.g. to perform a specific role in a multi-manager portfolio or because of a strong view on certain asset classes), can invest in strategies where the manager seeks to outperform this sub-asset class benchmark over a cycle.

- **Flexible:** Investors with more flexibility, but still seeking benchmark-relative returns, can target strategies which span multiple asset classes, but allow their active manager some flexibility to allocate between these sub-asset classes. These strategies aim to produced higher overall returns and lower volatility than holding separate single asset class investments as managers have an additional active lever to pull.

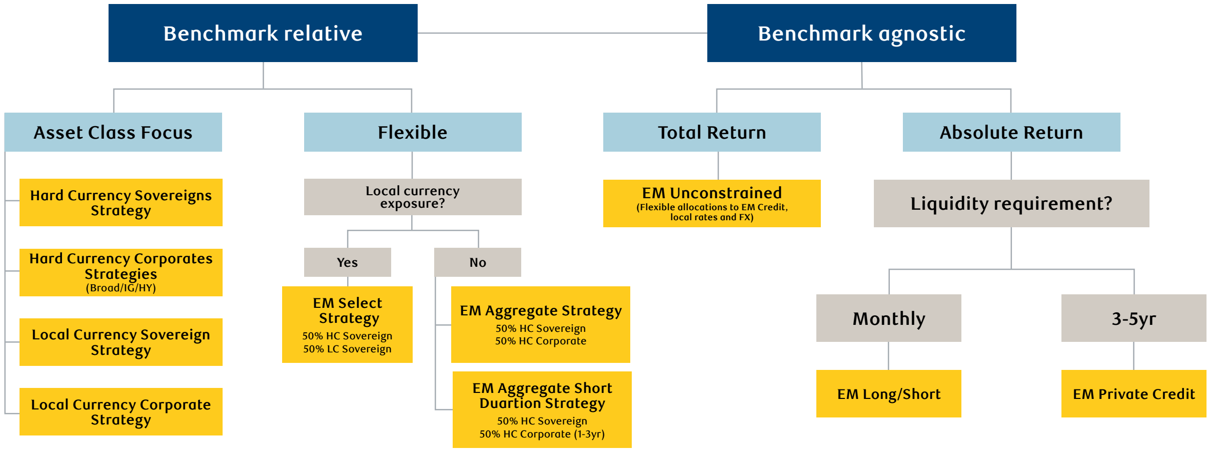
Benchmark agnostic

- **Total return, unconstrained (long-biased):** These ‘go anywhere’ strategies are for investors who want the ability to capture the attractive upside available in EMD though a high conviction portfolio, but would like more flexibility to limit the downside during periods of high volatility, often using derivatives to manage risk quickly and efficiently. These are still long-biased solutions, but without the constraints of a market benchmark. They can help to smoothen the volatility of investments over the long term.

- **Absolute return, long/short (hedge fund):** For investors who have the ability to allocate to long/short hedge funds, these strategies are similar to unconstrained strategies but have the added ability to short bonds. These are designed to be market neutral and generate strong positive returns irrespective of the underlying market environment. Typically, liquidity will be limited to monthly or longer and net return targets will be double-digits.

- **Private credit:** For investors able to lock up their capital for multiple years, a private credit strategy can target 15+% gross and net IRR in excess of 12%, annualised. In an uncertain and volatile environment, when demand for EM corporate issuance may be unreliable, healthy corporates in EM often choose the private credit route for funding smaller or shorter maturity financing requirements, often at a premium versus their funding costs in the liquid, public markets. As a result, investors in EM private credit can earn a healthy premium whilst still focusing on higher quality credits. At times, private market lenders, particularly banks, will need to reduce their balance sheets for reasons unrelated to the specific underlying assets. Given the illiquid nature of the private credit markets within EM, this activity can cause temporary asset price dislocations. Investors in a position to take advantage of these dislocations can generate an additional return pick up in their private credit portfolios.

Figure 1: Finding the best solution for EMD exposures



Source: RBC GAM, as at December 2024.

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