BlueBay
Asset Management

EMERGING MARKET DEBT: IN PRAISE OF UNCONSTRAINED INVESTING

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The rise of unconstrained investing

With the global economy transitioning from an era of monetary easing to monetary tightening, we have seen rising interest in emerging market debt (EMD) from investors attracted to the potential of higher yields and the portfolio diversification benefits that the asset class offers.

But due to the periodic volatility inherent to EMD, there has also been significant dispersion in the investor experience, depending on factors including the choice of sub-asset class (beta)* and the timing of capital deployment into the asset class.

In response, we have seen a proliferation of new unconstrained/total return/absolute return strategies in the EMD universe – each one with its own philosophy and unique portfolio construction approach, but all promising a smoother return experience. The presumed superiority of such strategies over traditional approaches has, however, been subject to much debate.

We believe this debate took a more urgent turn in 2018 and into 2019 for two principal reasons:

1. An increase in **market volatility** prompted investors to reflect on how best to access the opportunity set.

2. Many of the unconstrained strategies have delivered **mixed return profiles**, highlighting our long-held belief that it takes several market cycles to test and determine the true merits of such an approach.

*EMD has four sub-asset classes:

a. Hard currency sovereign debt (denoted by JPMorgan EMBI Global Diversified Index)
b. Hard currency corporate debt (denoted by JPMorgan CEMBI Diversified Index)
c. Local currency sovereign debt (denoted by JPMorgan GBI-EM Global Diversified Index)
d. Local currency corporate debt (denoted by BofA ML Emerging Market Non-Sovereign Debt Index)

Why an unconstrained approach in EMD makes sense

Historically, we have seen most investors allocating to EMD via benchmarked solutions. While these hold merit during certain parts of the economic cycle, a benchmark agnostic – aka 'unconstrained' – strategy can open a portfolio up to a wider opportunity set, offering a potentially value-additive approach.

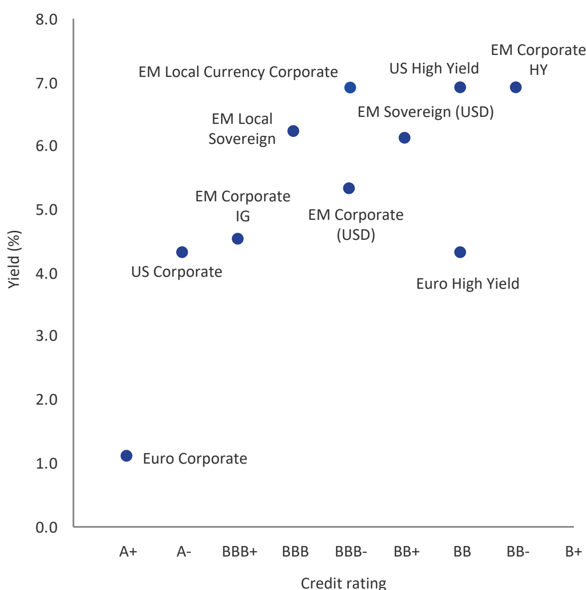
1. Value and volatility

EMD offers investors many benefits, but these can come with potential pitfalls too.

Among the positives, it can act as a portfolio diversifier, rich in idiosyncratic drivers of economic returns ranging from Chinese internet companies to Nigerian local currency debt, to cite just two examples.

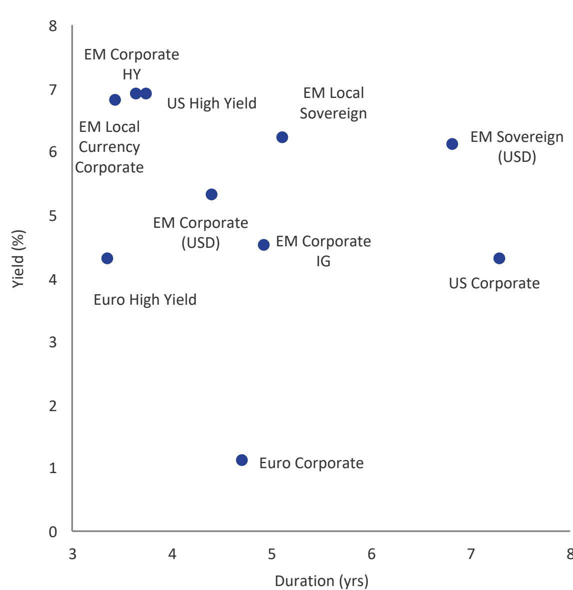
It also serves as a great store of value – current yields range from 5-7% at the index level and rise to around 8% when looking at instruments rated BB or below. This attractive yield premium offered by EMD becomes apparent when comparing the asset class against developed market instruments with similar rating and duration risk profiles (charts 1 and 2).

CHART 1: CREDIT RATING RELATIVE TO YIELD



Source: Bloomberg, March 2019

CHART 2: DURATION RELATIVE TO YIELD



Source: Bloomberg, March 2019

The potential value in the asset class becomes even more evident during periods of positive sentiment, where EMD investors can experience returns ranging from 5% to 15%.

However, as with all volatile asset classes, EMD is also prone to periods of meaningful devaluation.

This turbulence, measured through annualised volatility, warns investors not to expect uninterrupted positive returns from the asset class through carry alone. Chart 3 shows the volatility of the various sub-asset classes of EMD and compares them against a range of developed market asset classes.

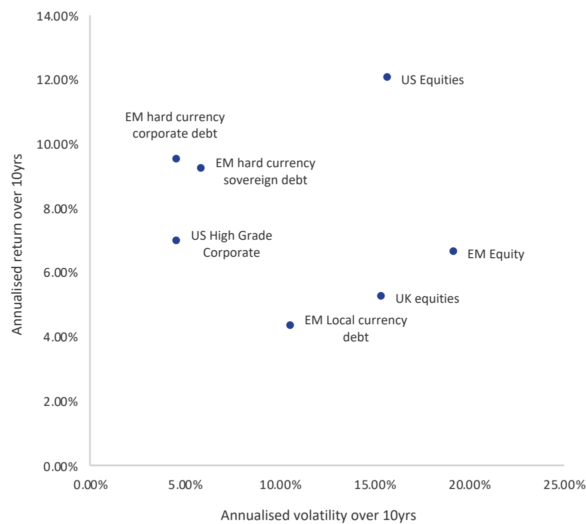
EMD assets are also driven by technical factors (such as positioning or liquidity) to a greater extent than other core fixed income asset classes due to the fact that EMD generally accounts for a much smaller proportion of institutional investors' strategic allocation.

As a result, off-benchmark tactical allocations by institutional investors (so-called 'tourist money') can exaggerate price moves in both positive and negative directions, accentuating overall volatility, although the degree of sensitivity to these moves can vary across the sub-asset classes.

One conclusion we can draw from this is that a long-only benchmarked solution targeting any EMD sub-asset class can prove successful during certain parts of the economic cycle, but the overall success of such investments depends as much on the timing of investment as it does on manager skill and the selection of underlying beta.

An unconstrained solution explicitly targeting downside protection while capturing most of the upside can smoothen the volatility of investments over the long term.

CHART 3: EM ASSETS ARE COMPELLING FROM A RISK/RETURN PERSPECTIVE



Source: JPMorgan, Bloomberg, March 2019

CHART 4: EMD SUB-ASSET CLASS RETURNS, 2007–2018

2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
EMFX 11.4%	Local Rates 10.8%	EM Corporate 38.6%	EM Corporate 13.5%	Local Rates 13.7%	EM Sovereign 17.4%	Local Rates -0.3%	Local Rates 8.2%	Local Rates 3.3%	EM Corporate 10.4%	EM Sovereign 10.3%	Local Rates 3.1%
Local Rates 6.7%	EM Sovereign -12.0%	EM Sovereign 29.8%	EM Sovereign 12.2%	EM Sovereign 7.3%	EM Corporate 17.0%	EM Corporate -1.7%	EM Sovereign 7.4%	EM Corporate 1.3%	EM Sovereign 10.2%	Local Rates 8.9%	EM Corporate -1.7%
EM Sovereign 6.2%	EM Corporate -15.4%	EMFX 11.7%	Local Rates 11.4%	EM Corporate 3.2%	Local Rates 13.7%	EM Sovereign -5.3%	EM Corporate 5.7%	EM Sovereign 1.2%	Local Rates 9.4%	EM Corporate 7.9%	EM Sovereign -4.2%
EM Corporate 3.5%	EMFX -16.0%	Local Rates 10.3%	EMFX 4.3%	EMFX -15.5%	EMFX 3.1%	EMFX -8.7%	EMFX -13.9%	EMFX -18.2%	EMFX -0.6%	EMFX 5.8%	EMFX -9.2%

Difference between the best and worst performing EM sub-asset classes

2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
7.9%	26.8%	28.3%	9.2%	29.2%	14.3%	8.4%	22.1%	21.5%	11.0%	4.5%	12.3%

EM Sovereign · EMFX · EM Corporate · Local Rates

Source: Bloomberg, as at 31 December 2018

2: Asset allocation

EMD comprises four main sub-asset classes:

- **USD-denominated sovereign debt** (denoted by JPMorgan EMBI Global Diversified Index)
- **USD-denominated corporate debt** (denoted by JPMorgan CEMBI Diversified Index)
- **Local currency-denominated sovereign debt** (denoted by JPMorgan GBI-EM Global Diversified Index)
- **Local-currency denominated corporate debt** (denoted by BofA ML Emerging Market Non-Sovereign Debt Index)

Although these sub-asset classes exhibit broadly high inter-correlation over the long term, during periods of drawdown, this correlation can weaken.

Additionally, in the world of EM, both US dollar and local currency-denominated corporate asset classes generally exhibit less volatility compared to the respective sovereign asset classes.

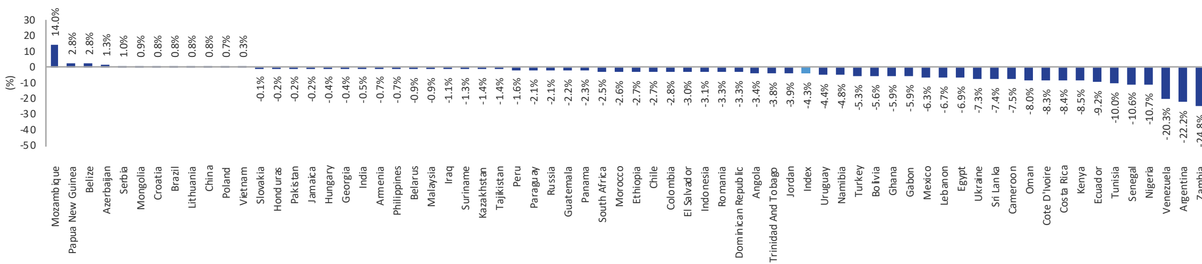
This is partly because the various sub-asset classes have differing sources of returns (interest rates and spreads for hard currency sectors; local rates and FX for the local currency sectors), driven by idiosyncratic fundamental and technical factors.

As a result, active asset allocation across these sub-asset classes can be an important source of value, as demonstrated by the dispersion between best and worst asset-class returns in chart 4.

Even within a single sub-asset class itself, the various constituents can produce highly differentiated returns. Charts 5, 6 and 7 show how the various components of both hard and local currency sovereign indices produced markedly differentiated returns during 2018.

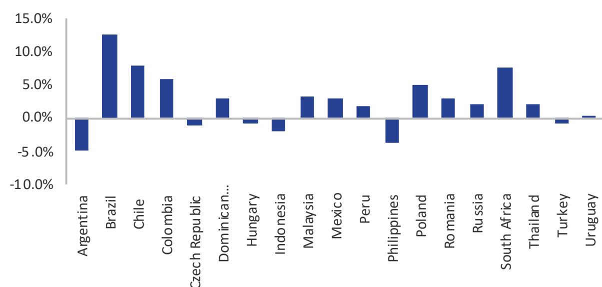
If investors can take advantage of these dispersions through both active asset allocation and asset selection, it should be possible to produce better returns. In our view, only an unconstrained strategy can consistently exploit the full spectrum of opportunities, making it a better solution for investors looking for superior returns.

CHART 5: HARD CURRENCY – COUNTRY TOTAL RETURN, 2018 (%)



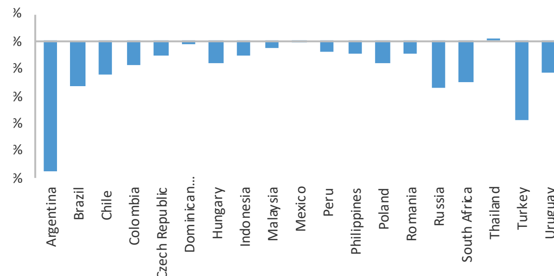
Source: JPMorgan, as at 31 December 2018

CHART 6: LOCAL CURRENCY – INTEREST RATE RETURN, 2018



Source: JPMorgan, as at 31 December 2018

CHART 7: LOCAL CURRENCY – FX RETURN, 2018



Source: JPMorgan, as at 31 December 2018

3. Off-benchmark opportunity set

Although the benchmarks of the EMD universe are generally robust and suitably diversified, we often find greater value in off-benchmark investments.

Why? Three reasons:

1. **Local currency corporate assets** are often not part of investors' permitted security universe, but our experience shows that, on a highly selective basis, it is possible to add value using these instruments – liquidity permitting.

2. Technical support from **index inclusion** can often be a powerful source of return. Middle Eastern countries such as Qatar and Saudi Arabia – where the spreads were attractive relative to the rating but the instruments were not part of the JPMorgan EMBI Global Diversified Index until February 2019 – strongly benefitted throughout 2018 from the technical support coming from expected index inclusion.

3. Across the vast EMD opportunity set, it is often possible to find instruments that do not strictly satisfy the benchmark criteria but can provide **asymmetric return profiles**.

Although some of these investments can be held on an off-benchmark basis in traditional benchmarked portfolios, only an unconstrained strategy can capitalise on these opportunities with statistical significance, due to potentially much larger position sizing.

Practical application: Ukrainian GDP-linked warrants

As part of the debt restructuring programme undertaken in consultation with the IMF, the Ukrainian government issued GDP-linked warrants to investors in late 2015. Due to embedded equity-like features, these instruments were not made part of the bond indices. The returns from these instruments remained lacklustre until 2017 when an upgraded recommendation from a research house led to these instruments rallying, supported by a fundamental rebound in Ukraine. The warrants generated nearly 80% in returns during 2017.

CHART 8: UKRAINE GDP WARRANTS

Source: Bloomberg, as at 31 March 2019

4. Asymmetry of hedging

Fortunately for EMD investors, it is possible to select hedging instruments that offer asymmetric return profiles. Due to the inefficiency of the asset class, well-recognised risk factors can be notably underpriced, offering an efficient way of hedging some of the risks.

Practical application: Asymmetry of hedging using liquid CDS instrument

A recent example of such asymmetry comes from Russia. In October 2018, when the oil price was near its three-year high and the risk of further sanctions from the US towards Russia was also very high, Russian CDS was trading, in our opinion, quite tight and therefore did not reflect the full extent of risk. If one would have reasonably expected further sanctions to materialise around Russia, purchasing CDS protection at that time may have offered a measure of downside protection.

As an oil-exporting country, Russia's CDS is also sensitive to oil prices, making short positions potentially helpful when managing long exposures to other oil-exporting countries.

Subsequent flare-ups in geopolitical risk and a nearly 40% drop in the oil price between September and November 2018 meant that Russian CDS spreads widened.

Such hedging strategies, when systematically implemented, are designed with downside protection in mind in an effort to help preserve returns for investors during a market drawdown.

CHART 9: RUSSIA FIVE-YEAR CDS AND OIL PRICE

Source: Bloomberg, December 2018

5. Sources of uncorrelated returns

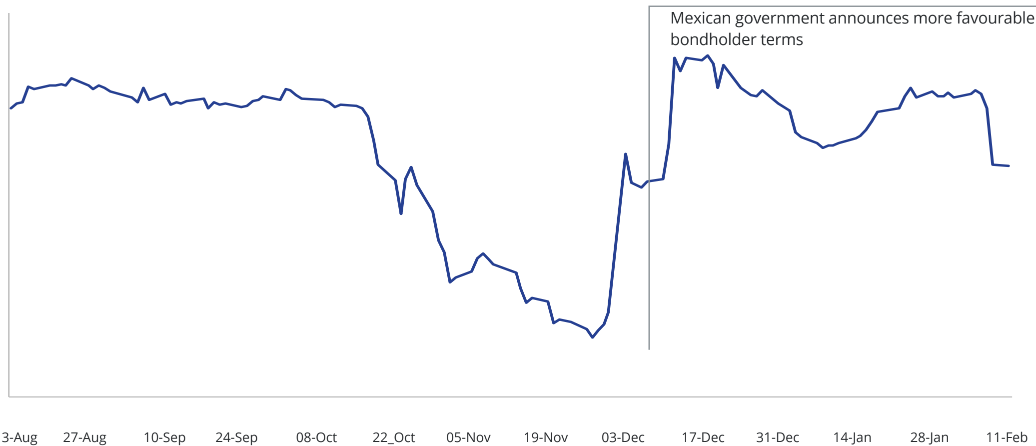
As a manager active across the whole spectrum of the asset class with a large team of analysts, we are capable of sourcing trade ideas from less researched or distressed assets. Occasionally, these trades can provide a valuable source of returns uncorrelated to broader market dynamics.

Practical application: Uncorrelated sources of returns from MEXCAT bonds

One such example concerns Mexican City Airport trust bonds, which were issued to finance an alternative airport in Mexico City. Despite the market volatility in 2018, these bonds looked solid until President Andrés Manuel López Obrador announced a referendum on the airport project, which ultimately resulted in the project being cancelled altogether. The bonds fell precipitously, as evidenced in chart 10, but our analysts' view was that the government was likely to offer better bondholder terms eventually.

In early December, the government offered better bondholder terms and the bonds subsequently rallied.

CHART 10: MEXCAT 2047 BOND PERFORMANCE (PRICE ON Y AXIS)



Source: Bloomberg, BlueBay Asset Management, February 2019. For informative purposes only.

As striking as the return dynamics were, the true differentiator was in the return profile against the market background. At a time when these bonds generated nearly 25% return, almost all developed market and EM equity and debt indices were in negative territory. As such, the bonds not only provided a compelling idiosyncratic source of return, they also provided a much sought-after uncorrelated return stream during a period of market weakness.

Conclusion

Benchmarked strategies, whether single or multi-sector, provide the illusion of discipline through strict risk budgets and guidelines, but can restrict investors' ability to both generate and preserve superior returns across market cycles.

Given the many twists and turns of the EMD asset class, its technical nature, vast opportunity set and inefficiency leading to asymmetry of returns, we have found that an unconstrained strategy is best placed to meet the needs of clients looking to harness the optimal returns in a risk-adjusted manner.

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