

# Beyond emerging markets: unlocking benefits of frontier local currency debt

Frontier local currency debt is among the most overlooked corners of the global fixed income market, yet it offers a rare mix of diversification, yield, and – contrary to popular belief – relatively low volatility. Building on the familiar case for emerging market debt, frontier markets take investors a step further into smaller, less crowded economies that remain far off the radar of most global allocators. Few are better positioned for this challenge than Aktia's Emerging Markets team, which has been managing the Aktia EM Frontier Bond+ strategy for nearly a decade.

## Defining the Frontier

While frontier local currency debt has distinct characteristics, the boundary between “frontier” and broader emerging markets is anything but clear-cut. Many economies classified as frontier share similar features with the smaller or less liquid segments of emerging markets.

In practice, the “frontier” label typically applies to economies at earlier stages of development, characterized by lower GDP per capita, stronger demographics, and a lower degree of integration into the global economy. “Pure frontiers often have lower debt-to-GDP, higher growth potential, more inflation volatility, and a healthier demographic pyramid,” according to Henrik Paldynski, Head of Aktia's Emerging Markets Team and Portfolio Manager. Inflation dynamics, for example, can be heavily influenced by domestic factors such as harvest outcomes, which can sometimes result in greater volatility in consumer prices. These features underpin the asset class's appeal: higher growth prospects, low correlation with other asset classes, and, perhaps counterintuitively, often lower volatility.

## Diversification Beyond Emerging Markets

Beyond the obvious advantage of higher carry, emerging market local currency debt already stands out for offering lower correlation to global equities than hard currency emerging market debt, even though both are government-issued. The difference is that one is denominated in local currencies, the other in U.S. dollars. “Frontier local currency investments take that a step further,” notes Paldynski. “The correlation to global equities goes all the way down to zero.” This unique diversification benefit stems from the wide range of issuing countries and the unusually broad credit-quality spectrum, creating a mix of rates-like exposure in stronger issuers and credit-driven dynamics in weaker ones.

## Why Passive Doesn't Work

“There's the old cliché that indexes are filled with the countries or issuers that borrow the most,” Paldynski says, pointing to the first problem with passive exposure to frontier local currency debt. A second issue lies in the lack of consideration for cross-correlations and concentrated risk factors. For example, many frontier markets are commodity exporters, meaning index exposure could be overly driven by oil prices or other single factors. This is where active management becomes critical. “The role of the portfolio manager is not only to understand each investment on its own, but also to understand what is created when they are combined into a portfolio. None of that is captured in passive approaches.”

## High Yields, Low Volatility

Diversification and low correlation are valuable in any portfolio, but one of the strongest attractions of frontier local currency debt is its high carry relative to other fixed income segments. As Paldynski notes, yields span a wide spectrum, from single digits in more stable frontier countries to significantly higher levels in distressed or turnaround markets. What surprises many investors is that these elevated yields are often paired with lower volatility. “That's the eureka or wow moment for most who get familiar with the asset class,” Paldynski says. “The issuers themselves

may be anything but boring, yet the portfolio as a whole ends up behaving in a surprisingly stable and predictable way.”

Frontier local currency debt also benefits from a structural cushion: very low beta, short duration, and high yields-to-worst, all of which help offset foreign exchange volatility or rising interest rates. Several factors underpin this low-volatility profile.

First, frontier bonds typically have much shorter duration, roughly half that of emerging market local currency debt or hard currency debt. “With limited demand for long-dated issuance, maturities tend to be shorter and yields higher,” he adds. Second, foreign investor participation is limited, reducing the risk of sharp outflows driven by global “risk-on, risk-off” sentiment. Finally, many frontier currencies are actively managed. “You often have central bank intervention, crawling pegs, managed floats, or other mechanisms that dampen exchange rate volatility,” says Paldynski.

## Understanding the Risks

Given the unique characteristics of each frontier country, the risks in local currency debt vary widely. Investors often ask about defaults and restructurings, but Paldynski points out that such events are far less common in local currency debt than in hard currency issues. “Hard-currency investors are mostly foreign, whereas local currency debt is primarily held by domestic institutions such as banks and pension funds. It simply doesn't make sense for governments to jeopardize their domestic financial system,” he explains. Instead, the principal risk for frontier local currency debt is foreign exchange exposure. “FX risk is really the most important factor,” Paldynski emphasizes.

“For a foreign investor, a 50 percent haircut on debt or a 50 percent currency devaluation can feel essentially the same,” Paldynski notes. This is why Aktia devotes significant focus to managing FX risk. Historically, frontier currencies tend to depreciate against the U.S. dollar due to higher average inflation. “Currencies usually adjust to maintain real competitiveness,” he explains. While there may be exceptions in certain years – for example, 2025 may see little or no depreciation – historically, the depreciation path has been the largest single detractor from total returns in frontier local currency debt. “The good news is that over the long term, the aggregate depreciation path has been stable and, in many cases, predictable.”

## A Decade of Experience

The Aktia EM Frontier Bond+ strategy is approaching its ten-year anniversary, having navigated a decade that has generally been challenging for fixed-income investments. “The past ten years haven't been great for any type of fixed income, but they've been an excellent litmus test for the strategy,” Paldynski reflects.

A factor that could enhance the appeal of frontier local currency debt is a shift in U.S. investment dynamics. “A somewhat less dominant U.S. could actually be positive for the next ten years,” he concludes, highlighting the potential for frontier markets to capture renewed global investor attention.



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