Is there upside on emerging debt?

Interview with Jean-Jacques Durand, manager of the Edmond de Rothschild Emerging Bonds fund

Jean-Jacques Durand

At the beginning of 2014, most investors were cautious on emerging debt. Has the market proved them right?

No, contrary to expectations, the emerging debt market has risen sharply since the beginning of the year. The JPM EMBI Global Hedged (EUR) index is up 9.3%[1] so far this year and was even flirting with 10% only a few days ago.

Unlike the consensus, we had been rather positive on emerging debt since last autumn as we found valuations attractive and technical factors generally favourable. That is why we chose to reduce our cash position and gradually take on more risk. We saw the market advancing by 5-10% in 2014 so it has so far performed better than we expected.

There are two main reasons for this: first, lower US yields as the recovery stalled in the first half, support from the Fed and persistently tame inflation. Second, attractive spreads on emerging debt and favourable investor positioning.

And yet there were numerous areas of concern that could have had negative consequences and stopped markets rising, notably political risk from elections in emerging countries and geopolitical risk in Ukraine, Iraq and the Middle East. These risks are still present but markets have proved robust thanks mainly to technical factors.

Many investors underestimated the potential returns from emerging debt and volumes remained relatively modest.

The overall market still has upside for the rest of 2014 but any further advance could well be limited after the rises seen in recent months. Net issuance of sovereign debt should decline, a positive factor per se, but some valuations are now less attractive. We do, however, believe that the sort of non-benchmarked active management deployed by Edmond de Rothschild Emerging Bonds is geared to the current environment. The long term trend on these markets is favourable and there are still opportunities, regardless of the environment. Every year, outperformance in the emerging debt segment hinges on a few specific stories or themes. These are the sort of factors we seek to identify.

What are your strongest investment convictions?

Our portfolio is currently concentrated on around 20 positions. We sharply reduced the money market allocation at the end of 2013 but have increased it since. The portfolio is now 75% exposed to the market[1].

Our biggest position is still Venezuela. We reduced exposure from 20% to around 14% at the beginning of the year but we think the country still offers upside and attractive valuations. The government is becoming more pragmatic and needs to introduce the necessary reforms and tackle imbalances.

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Another big bet is Ukraine. In spite of the dramatic events in the country, we feel that over the medium term it is moving towards a period of normalisation. It has the support of the IMF and that should help it meet payment deadlines. The government enjoys strong legitimacy and is expected to put forward a sweeping reform programme.

Elsewhere, we hedged Chinese exposure at the beginning of June. There are serious worries over a credit bubble and we believe China's sovereign credit risk has not been fully discounted. The improved market environment and encouraging Chinese PMI data helped us hedge at attractive prices.

As a result, Edmond de Rothschild Emerging Bonds has risen 13.3%[2] year to date, outperforming its benchmark index by close to 4%.

Company Profile:

Asset management is one of the Edmond de Rothschild Group's two strategic businesses. The Group was founded in 1953 and has been chaired since 1997 by Baron Benjamin de Rothschild. An independent, family-owned group that also specialises in private banking, the group has EUR 135.7bn under management and employs 2,800 people in 31 offices throughout the world.

With 6 investment hubs in the world (France, Switzerland, Germany, Hong Kong, Luxembourg and the UK), the Asset Management business of the Edmond de Rothschild Group is positioned as a multi specialist investment firm. Its offer seeks long term performance through active investing and strong convictions based on a tradition of constant innovation.

This builds on recognized areas of expertise such as European and US equities, corporate debt, multi manager, overlay management, asset allocation and quantitative asset management.

The Asset Management business of the Edmond de Rothschild group had EUR 45.5bn under management at December 31 2013 and employed 550 people including 100 investment professionals.

The fund's main risks are: capital loss risk, discretionary management risk, credit risk, interest rate risk, credit risk linked to investment in speculative securities, risks associated with investing in emerging markets, currency risk, equity risk, risk associated with financial contract exposure and counterparty risk, risk associated with commodities, liquidity risk, risk associated with hybrid products (convertible bonds).

The fund (I share) is classified in category 4 in line with the nature of securities and geographical zones in the "objectives and investment policy" section of the key investor information document (KIID).

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1. Past figures refer to previous years and are not a reliable indication of future returns. Data for the I share as of 21/07/2014. Source: Edmond de Rothschild Asset Management (France)
2. Past figures refer to previous years and are not a reliable indication of future returns. Data for the I share as of 21/07/2014. Source: Edmond de Rothschild Asset Management (France). I share cumulated returns since inception (04/03/2011): +49.61% versus 22.74% for its benchmark. The fund's benchmark is the JPM EMBI Global Index hedged in euros.

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