Emerging market corporate bonds offer sustainable opportunities

Emerging market (EM) corporate bonds and sustainability may seem like an unusual combination at first glance. EM bonds are not traditionally regarded as sustainable investments. Nevertheless, more and more companies in the emerging markets meet the relevant criteria and thus meet an investor requirement.

Almost two-thirds of institutional investors from Europe who took part in a study conducted by Union Investment said that sustainability was one of their considerations when constructing their portfolio. At the same time, EM investments provide the sort of superior returns that stopped being achievable in other regions a long time ago.

One of the main advantages of EM corporate bonds is their comparatively low susceptibility to fluctuation. This is attributable not only to the composition of the group of issuers – financial bonds comprise more than a third of all companies – but also to the relatively short duration. Further support is provided by declining issuance activity, with a steady fall in primary market activity since the record year of 2014. The reasons for this decrease are the sometimes volatile conditions in stock markets and the fact that companies already have good capital resources. Moreover, companies are again increasingly opting for issues and loans denominated in their local currencies, some of which have appreciated significantly in the past few months.

The market is now increasingly dominated by Asian names. Around 60 per cent of new issues come from Asia – and China is at the forefront. However, issuers from Brazil, Russia and the Middle East are also in the spotlight. Companies from Latin America and Africa have been the best performers so far this year, with their credit spreads having each fallen by approximately 150 basis points since early January.

Developments have primarily been shaped by companies in the volatile commodity sectors. January initially saw sharp falls in commodity prices, which put particularly strong pressure on representatives of the oil & gas and metals & mining industries. However, the oil price then rallied – as did prices of precious and industrial metals – which meant it was precisely these companies that registered a considerable narrowing of credit spreads. This puts them among the winners of 2016 so far. Some issuers, such as Brazil's semi-state-owned oil company Petrobras, also used this market phase for primary market issues, some of which had been postponed for a long time.

LOW BORROWING, FAVOURABLE PRICING

Investors in EM corporate bonds can also benefit from their attractive valuation. Because of negative headlines and some adverse trends in the past, the asset class is comparatively cheap, despite the fact that the fundamentals often look a lot more positive. The level of indebtedness of many EM companies is

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now no worse or sometimes even better than that of their counterparts in developed countries. Importantly, default rates in emerging markets are no higher than those in industrialised countries, either. Finally, many companies from the emerging markets are now increasingly likely to operate globally. This makes them less dependent on their more volatile domestic markets and enables them to generate revenue in US dollars or euros at the same time, which is important when it comes to servicing the bonds in these currencies.

It is also worth noting that credit ratings –supposedly the biggest risk of this asset class – do not sufficiently reflect the fundamental strength of many companies because these are predominantly based on the creditworthiness of companies' home countries. If a country loses its investment-grade rating, it is almost expected that companies in that country will also be downgraded even if their fundamental situation has changed only marginally or not at all. Russia and Brazil, for example, now have barely any issuers with investment-grade credit ratings, despite companies' generally good performance. This practice presents interesting investment opportunities with manageable risk, including in the high-yield segment.

PROPRIETARY TOOL FOR COMPREHENSIVE RESEARCH

Detailed analysis enabling an accurate assessment of the different influencing factors remains crucial to investment performance. In addition to a multi-stage research process combining top-down and bottom-up approaches, the sustainability aspect can also be helpful. This is because such analysis ensures an even more defensive portfolio focus due to the underweight position of certain industries or regions.

In addition to the expertise of each of our portfolio managers, who take these aspects into consideration in the investment process, Union Investment has developed a proprietary Sustainable Investment Research Information System (SIRIS). This system holds additional information on every issuer that has been compiled by a team of sustainability specialists. The criteria include the International Labour Organization standards and the proportion of revenue generated from business lines such as armaments, gambling and tobacco or alcohol production. Using this system, around 400 names from the EM universe were analysed in cooperation with the experts on the EM corporate bond team. This analysis found that, according to the selected criteria, about a third of the companies had too high a level of event risk, reputational risk, regulatory risk or litigation risk and therefore did not belong in a fund focused on sustainability. One of the steps that this constantly updated analysis has enabled us to take is to include more green bonds from India's Axis Bank in our portfolios. These bonds were issued to fund renewable energy projects. On the flip side, Mexican state oil company Pemex has a high level of corruption according to our research, which is why these bonds are not suitable for our sustainability-oriented investment briefs.

Alongside these general criteria, the filter can also be expanded to include customer-specific criteria. In bespoke fund solutions, certain business models, sectors or entire regions can be excluded, or particular risks can be deliberately entered into, which gives the investment an individual risk profile. As one of the biggest asset managers for EM corporate bonds in the German-speaking countries, we do not simply achieve the superior returns that our domestic and international customers urgently require. We also take adequate consideration of sustainability criteria, which are becoming increasingly important factors, in mutual and special funds.