A BLENDED APPROACH TO EMERGING MARKET DEBT

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As more investors look outside traditional government bonds in order to generate a reasonable yield in what is a historical low-yielding environment, Emerging Market Debt (EMD) has been a significant beneficiary of the reallocation. But our research suggests that many investors looking at the EMD space might be missing the diversification[1] they are seeking by adhering to an approach that risks remaining, in large part, correlated with traditional fixed income portfolios. Our analysis indicates an allocation to blended factors could offer superior longer-term risk/reward outcomes.

Over the last decade, we have seen the EMD asset class grow significantly in size as more issuers have come to market which in turn has increased the opportunity set available to investors. And in the last year in particular, there have been significant inflows into the asset class. In spite of this, yields for EMD remain significantly elevated in comparison to their developed market peers, and in line with their longer term historical averages.

Yield to Maturity of Average Benchmark Indices

These inflows have helped support strong returns delivered by many EM sovereigns and corporates, but a lot of this capital has been placed into more traditional EM issuers, such as Mexico and Poland, which could diminish the potential diversification benefit and potentially concentrate investors' risks. Borrowers such as Mexico and Poland have been able to issue long duration debt in US dollars and euros, which now offer minimal spread over benchmark US Treasuries or German Bunds. Therefore most of the risk being taken could actually be considered US or German sovereign risk, with only a small component being the credit spread for the Mexico or Polish risk.

DIVERSIFICATION AND AN ACTIVE APPROACH

The diversification that EMD could potentially bring to existing portfolios of developed market fixed income securities can come from various factors as can be seen in the table below.

Correlations Between Emerging and Developed Market Portfolios*
5 Year-Correlation: 2011–2016

	US Treasuries	Global Treasuries (USD Unhedged)	Global Treasuries (USD Hedged)	Global Aggregate Bonds (USD Hedged)	US Investment Grade Corporates
EM Sovereigns					
Local Currency	0.21	0.59	0.08	0.26	0.51
Hard Currency	0.05	0.56	0.23	0.43	0.65
EM Corporates					
Hard Currency (USD Hedged)	-0.02	0.46	0.09	0.32	0.61

*Source: Franklin Templeton Investments, Barclays POINT as at 31st March 2016.

Notes: Local Currency EM Sovereigns are represented by the JP Morgan GBI-EM Broad Diversified Index; Hard Currency Sovereigns are represented by the JP Morgan EMBI Global Diversified Index; EM Corporates are represented by the BofA Merrill Lynch Emerging Market Corporate Plus Index; US Treasuries are represented by the Barclays US Treasury – Bills Index; US IG Corporates are represented by the Barclays US Corporate – Investment Grade Index; US High Yield is represented by the Barclays US High Yield – Corporate Index; Global Aggregate is represented by the Barclays Global Aggregate index; Global Treasuries are represented by the Barclays Global Treasury Index. Due to differences in calculation methodologies between internal risk database and official Benchmark provider, these statistics may not match the official statistics of the benchmark provider.

Looking at benchmarks, the most consistent and superior long-term risk/reward outcomes in euro terms have tended to be generated by a blended allocation to hard currency, local currency and corporate EMD.

Active allocation around these buckets does, of course, have the potential to improve the outcome even further, and the highly diverse nature of EMD should afford investment managers the opportunity to do just that. Given the stark differences in correlation of hard, local and corporate EMD versus a number of traditional fixed income markets, an active and blended approach to investing in the asset class could potentially provide investors with an effective way of increasing and reducing correlation to asset classes when appropriate to do so.

By applying this kind of blended approach to the asset class, an investor has the ability to better diversify an EMD allocation in relation to a broader fixed income portfolio. By being able to avoid those markets (or large exposures to those markets) that dominate indexes which are often more highly correlated to more traditional fixed income asset classes, a portfolio can be constructed to actively diversify from core fixed income portfolio holdings whilst still being able to capture the high yields on offer.

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1. Diversification does not guarantee profit nor protect against risk of loss.

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