EVOLUTION OF THE INVESTMENT APPROACH TO EMERGING MARKET DEBT

By Colm McDonagh, Head of Emerging Market Fixed Income

Emerging market fixed income is a maturing asset class. Its rapid growth in size, scale and complexity has meant that investors have had to adapt their investment approach over time to gain appropriate exposure given the many different risk and return drivers at play across the full spectrum. We believe a total return multi-asset approach is likely to play an increasingly important role in investor allocation behaviour.

Emerging markets (EM) have undergone a rapid transformation over the past two decades as their economies have quickly expanded to a point where they contribute more to global growth than developed economies.

The investment opportunity once largely centred on US dollar-denominated government EM assets, but has evolved to now include new asset class segments, including local currency government debt and, in more recent prominence, EM corporate debt. Given the multitude of and interplay between different risk and return drivers over time, the need for a change in approach to extract value from emerging market debt (EMD) has become increasingly important. As long-term investors recognise, past experiences have not always delivered according to return expectations.

BACK TO BASICS

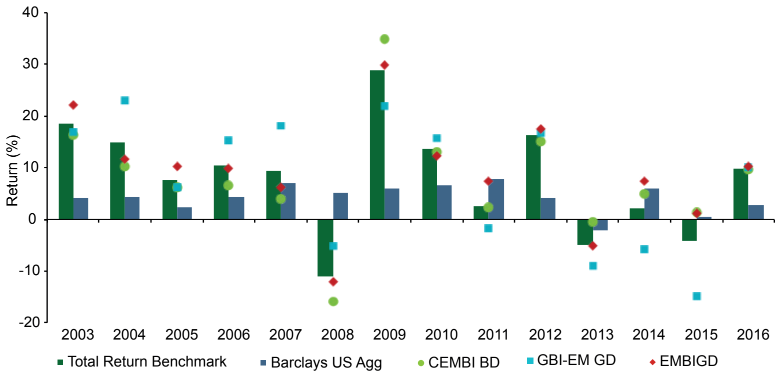
How investors access EM fixed income can have a significant impact on their risk/return profile. Investment managers have traditionally offered distinct sovereign, corporate and local currency EMD portfolios.

Mainstream fixed income indices have prominent weaknesses. The most common is that as an entity issues more debt, it will account for a higher proportion of the index. This has presented substantial difficulties in times of market stress, meaning even conservative aggregate benchmarks have incurred the risk of tail events for investors.

EMD index investors rightly seek diversification, attractive income and capital gains that the asset class offers, however, they can suffer from a lack of liquidity, step changes in volatility and uncertainty over capital preservation. This is partly due to a lack of risk calibration because an EM index offers exposure to very different types of risk.

Whether a strategy focuses on external sovereign, external corporate or local currency sovereign debt, mainstream indices can incorporate underlying risks that undermine their ability to fulfil investors' objectives. This approach often means that investors end up being unintentionally structurally long EM currency and interest rate exposure when in fact they are targeting risk premium. In the current environment, where rates across the globe are low and in some cases negative, these considerations become less pertinent. However, as the global monetary cycle turns, such unintended exposures could leave investors vulnerable.

Flexible total return approach - captures market beta, less tail risk versus individual indices



Source: JPMorgan, Barclays and Insight, as at 31 December 2016. Total return benchmark: equal weighting between GBI-EM GD, EMBIGD and CEMBI BD indices.

Investors looking for beta have tended to lean towards traditional index allocations as building blocks but other issues concerning such an approach include questions around what an appropriate allocation between sub-asset classes should look like, the timing of these investments and whether such allocations ought to be fixed or flexible.

All of these considerations mean that investors are shifting focus to total return strategies which allow managers greater freedom to allocate tactically. This, in our view, marks the next milestone in the evolution of investors' approach to EMD investing: maintaining a structural beta allocation to a significantly greater degree than an absolute return approach but adding value by determining when that beta is cheap or expensive.

TOTAL RETURN APPROACHES

Although we are long-term proponents of absolute return within EM, we are cognisant that we may be some way off from absolute return being widely followed by EM fixed income investors. We do, however, recognise the importance of a total return approach as an important phase of investors' allocation behaviour.

While some strategies combine exposure to different segments of the market as part of the total return approach, portfolios are still typically managed with reference to mainstream indices seeking to minimise tracking error.

True total return strategies seek to enhance returns beyond those achieved by traditional index allocations by combining and actively managing exposures to sub-asset classes including local currency debt, external sovereign and corporate debt, tactically allocating between sub-asset classes in a bid to enhance returns. It is an approach that seeks out cheap beta through market cycles, rather than just beta alone. This is, in our view, a better way by which to optimise EM exposures compared to traditional benchmarked strategies.

Total return strategies such as these seek to harness the favourable characteristics exhibited by EM sovereigns, corporates and local debt, including portfolio diversification, income generation and capital growth, without returns being overly dominated by either US interest rate policy or moves in EM currencies.

The potential benefits for investors include greater scope for tactical and timely investment decisions within the asset class, including when to switch from sovereign to local debt (and vice versa) at a strategic asset class or country level. Ultimately it is about giving the investment team greater freedoms around the ability to allocate to sources of cheap beta across the sub-asset classes of the investment universe in a timely fashion.

MEASUREMENT

There remains a need to evaluate how an investment manager delivers this Total Return style of investment, to measure the "opportunity cost" of allocating to this approach.

In the early development of EMD investment, managers were benchmark "aware" and were required to outperform, but were less constrained in style.

We would argue that a suitable benchmark for an EM total return approach is an equal weighting between EM government debt, local currency debt and corporate debt.

Defining the benchmark in this way captures the structural premium offered by EM while removing the tail risks typically associated with individual index investing (Figure 1). Strategically including corporate debt enhances overall portfolio diversification without necessarily structurally moving investors out along the credit risk spectrum.

Through active decision making, the investment team seeks to reduce the volatility associated with unintended currency contribution to returns while also allowing a rotation between sub-asset classes depending on shifts in credit and interest rate cycles.

A true total return approach offers structural beta allocation to EM and allows the investment manager to source additional beta/alpha opportunities within sub-asset allocations to make relative country and security selection decisions.

In this way, if correctly managed, investors are, over the longer term, more insulated against the cyclicality of the asset class.

We have championed an absolute return approach to EMD for many years and think it is an ideal point from which to start delivering total return.

We believe that in order to manage a total return EMD fund successfully, a singular and holistic investment process across external, local and corporate debt that recognises the interdependency of these sub-asset classes is imperative and far superior than processes that attempt to harmonise distinct investment approaches that are often applied separately to each building block.

Insight's EMD Team has extensive experience, investing across the spectrum of the asset class including government, corporate and local currency instruments, through different market cycles and major market events. The team has broad and deep expertise across absolute return and EM corporate total return approaches and has demonstrated superior risk management relative to EM indices through difficult market periods.

By using the existing investment processes currently employed but with less exposure constraint and more structural beta exposure, there is the potential for superior risk-adjusted returns to be delivered on a total return basis.

Insight INVESTMENT