Mining Opportunities in Emerging Markets Corporate Debt

As emerging markets (EM) growth continues to outpace that of developed markets, these countries have taken on an increasingly important role in the dynamics of the global economy. Along with this growth, local credit markets in many EM countries have matured and EM debt has become a diversified mature asset class representing about 11% of the global fixed income universe.

EM corporate debt has helped fuel this growth. In fact, over the past 10 years, it has grown to the point where it now exceeds the market capitalisation of EM sovereign debt.

Yet some investors choose to forgo an allocation to EM corporate debt, possibly based on the misconception that it comes with greater risk and offers little additional benefit. We believe the compelling risk, return, and spread characteristics in this growing asset class have earned it a place in investor portfolios alongside allocations to other global credit investments.

Below, we explore the benefits of incorporating EM corporate debt into a diversified asset allocation framework. Looking deeper, we examine the relative value of EM corporate debt versus developed markets credit. Finally, we consider some of the complexities of EM debt investing.

EM corporate debt enhances diversification and portfolio returns

To illustrate its performance characteristics, we compared EM corporate debt to US high yield, which over the past 15 years has outperformed other fixed income categories. Key performance statistics illustrate the contrast between the two categories[1]:

➤ **Diversification:** EM corporate's low correlations to US equities (0.49) compare favourably to US high yield (0.68).

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➤ **Reduced volatility:** Standard deviation for EM corporate debt was 7.68%, while it was 9.63% for US high yield.

➤ **Lower downside risk:** Maximum drawdown for EM corporate debt was -24.30% versus -33.31% for US high yield.

In a traditional 60% equity/40% fixed income portfolio[2], risk is driven primarily by the equity allocation, so adding asset classes with lower correlations to equities should offer greater diversification – along with higher Sharpe Ratios.

We compared the impact on a 60/40 portfolio of adding a 5% allocation to EM corporate debt versus adding a 5% allocation to US high yield, and then examined their Sharpe Ratios[3]. Since 2002, the portfolio with the 5% allocation to EM corporate debt improved the Sharpe Ratio by 0.020 while a 5% allocation to US high yield improved the Sharpe Ratio by 0.017. Over the past 3 years, the differences were more significant: the portfolio with the 5% allocation to EM corporate debt improved the Sharpe Ratio by 0.013 while the Sharpe Ratio for the portfolio with a 5% allocation to US high yield remained flat.[4]

Less leverage with more spread

The EM corporate debt universe offers high credit quality with about 60% investment grade rated issuers. An examination of its relative spreads and leverage by credit quality compared to US credit reveals its attractive relative value.

Figure 1 presents a spread and leverage breakdown for US corporate credit versus EM corporate debt:

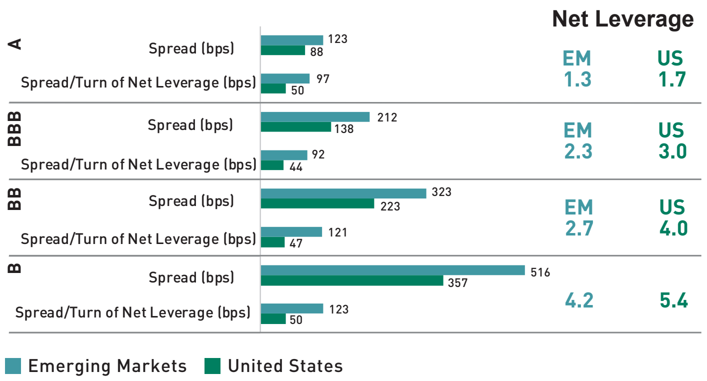
➤ **Lower leverage:** Similarly rated EM corporate debt issuers are generally less leveraged than their US counterparts.

➤ **Higher spreads:** EM corporate debt offers substantially higher spreads than US securities of the same quality.

➤ **Favourable spread/leverage profile:** Spread per turn of leverage is therefore more favourable for EM corporate debt than US securities, indicating that EM corporate debt pays investors more for the risk they take.

We believe EM corporate debt can offer improved risk-adjusted returns, diversification, and leverage characteristics compared to developed markets credit, earning it a place in strategic portfolio allocations.

Figure 1: EM Corporate Debt: A Favourable Spread/Leverage Profile



EM corporate debt is represented by the JP Morgan CEMBI Broad Diversified Index; US high yield is represented by Bloomberg Barclays US High Yield Index. Source: Bloomberg, Spread and Spread/Turn of Leverage data is as of 30/6/2017. Net Leverage data is as of 31/12/2016.

The Importance of Multi-Dimensional Analysis

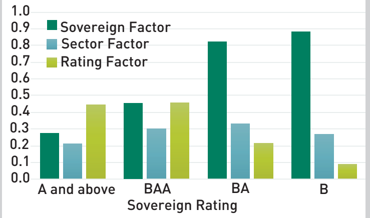
The EM corporate debt universe spans 50 countries that feature a wide range of levels of economic development, which presents both opportunities and challenges.

It includes companies in countries with sovereign ratings that are higher than the US, such as Singapore (AAA/AAA), France and South Korea (Aa2/AA/AA-), to distressed macroeconomic environments such as El Salvador (Caa1/CC/CCC) and Ukraine (Caa3/B-/B-).

This diversity translates into a wide range in the sophistication of operating environments, including business, regulatory, and capital markets infrastructure. To add to this complexity, sophisticated profitable companies with investment grade balance sheets are sometimes located in countries with low sovereign ratings, which often caps the rating of the corporate issue. Identifying hidden gems and avoiding pitfalls requires a deep understanding of the country's macroeconomic environment as well as global industry themes and idiosyncratic strengths and weaknesses of individual companies.

When does country risk matter? Not surprisingly, the lower the sovereign rating, the bigger the sensitivity of the corporate spread to country risk. To quantify the impact of country risk, credit rating and sector risk on a company's spread change, we tested it in a multivariable regression model. Our analysis indicated that the average beta of country/sector/credit rating for an EM issuer's spread was 0.35/0.25/0.37, respectively.

Figure 2: An Analysis of Credit Spread Drivers



Source: Bloomberg, American Century Investments. Data from 1/1/2011 to 30/6/2017

Yet our analysis, illustrated in Figure 2, indicates that the drivers of EM corporate spreads vary significantly from these averages. For companies in countries with a high sovereign rating, the company's own credit rating is the biggest driver of credit spread, while for companies in countries with a low sovereign rating, the country factor is typically the dominant driver of credit spreads.

Conclusion

EM corporate debt has become too big to ignore and offers an attractive risk and reward profile. In addition, the diversification benefits and historical performance profile suggest that incorporating EM corporate debt into a 60/40 portfolio may enhance risk-adjusted returns and improve Sharpe Ratios.

Yet the diversity of the EM corporate debt and the complexity of analysing the universe requires the specialised skill of an experienced active manager who can successfully navigate the landscape of sovereign risks and global industry drivers, in addition to the idiosyncratic credit risks of each company.

FOOTNOTES

1 Data from 1/1/2002 to 31/7/2017. Source: Bloomberg. EM corporate debt represented by JP Morgan CEMBI Broad Diversified Index; US High Yield represented by Bloomberg Barclays US High Yield Index.

2 Data as of 31/7/2017. Source: Bloomberg; equities represented by the S&P 500 Index; fixed income represented by Bloomberg Barclays US Aggregate Index.

3 The equity allocation was reduced by 3% and the bond allocation by 2% to add 5% in either EM Corporate (as represented by the JP Morgan CEMBI Index) or US High Yield (as represented by the Bloomberg Barclays US High Yield Index). This hypothetical situation contains assumptions that are intended for illustrative purposes only and are not representative of the performance of any security. There is no assurance similar results can be achieved, and this information should not be relied upon as a specific recommendation to buy or sell securities.

4 Source: Bloomberg; as of 31/7/2017.

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