Emerging Market Debt

Indexing on the Rise

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Emerging Market Debt (EMD) is one of the most rapidly evolving asset classes in investment markets. New developments are challenging some of the traditional perceptions around how to access it.

In the past, adopting an active management approach was perceived to be the best way to invest in EMD based on the following assumptions:

- An indexed exposure is too expensive to be implemented effectively in emerging markets.
- EMD is an inefficient market and detailed fundamental knowledge should enable active managers to identify and extract value.
- There are some obvious 'weak' segments of the universe that could drag performance down; active managers can avoid these, an option not open to those applying an index approach.

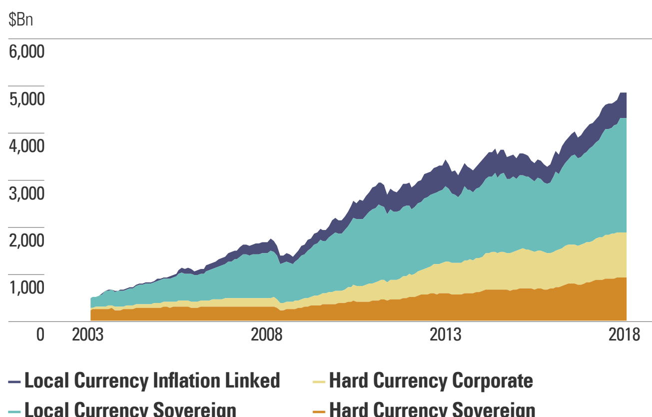
The reality is, however, very different. EMD now offers much greater liquidity and diversity, while the majority of active managers fail to outperform their benchmarks over the longer term. In this paper, we illustrate how the EMD universe has evolved and why an indexed approach is becoming accepted as a practical solution for this more complex exposure.

A LARGE, DIVERSE AND LIQUID UNIVERSE

The EMD universe has grown dramatically over the past decade, with the expansion of local currency markets acting as a primary catalyst. Importantly, not only has the EMD market grown in size, but the types of securities on offer have become much more diverse. For example, we have seen the emergence of local inflation-linked bonds, as well as hard currency and local currency corporate bonds. And while the local currency corporate bond universe is still a market reserved primarily for local investors, hard currency EM corporate bonds have gained increasing popularity with international investors.

Our analysis focuses on the investible universe based on the indices most followed by institutional investors in hard currency sovereign and corporate debt and in local currency nominal and inflation-linked debt. Based on our estimates this universe stood at US$ 4.9 trillion at the end of March 2018 (Figure 1). To put this in context, this is almost twice the size of the global high yield market, which is often seen as a more traditional growth asset for fixed income investors. It should also be noted that this is only a portion of the total market, estimated to be in excess of US$ 15 trillion, as it excludes the local currency markets of countries such as China and India and all local currency corporate debt.

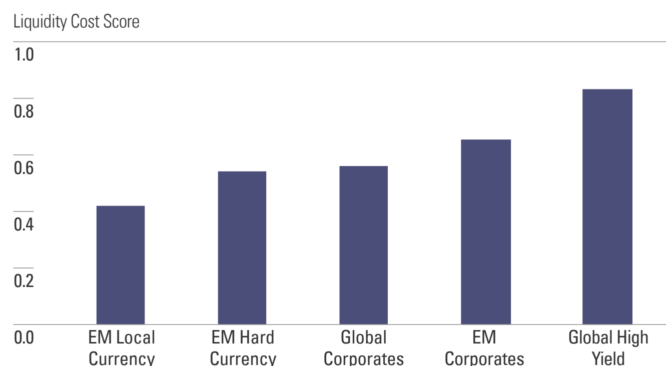
Figure 1: EMD Universe Expansion



Source: State Street Global Advisors, JP Morgan, Barclays as of March 31, 2018.

While the increase in market size has been well documented, the fact that EMD liquidity is now on a par with investment grade (IG) credit is less widely known. According to the Barclays Liquidity Cost Score (LCS), the cost of trading hard currency emerging market (EM) bonds is comparable with that of IG corporate bonds (Figure 2). For local currency EM bonds, trading costs are even lower. Interestingly, trading high yield bonds is currently twice as expensive as trading local currency EMD. At State Street Global Advisors, our experience of investing in and managing indexed EMD exposures for 13 years echoes these results from Barclays.

Figure 2: EMD Trading Costs Fall



Source: State Street Global Advisors, Bloomberg Barclays, JP Morgan, Barclays Point as of March 31, 2018.

ACTIVE VS PASSIVE IN EMD

The evolution of the EM fixed income universe has created opportunities that more and more investors are starting to appreciate and participate in. While active managers have struggled to consistently deliver excess returns, indexed strategies have evolved and developed sophisticated techniques capable of delivering the return of the benchmark in a cost-efficient manner.

We have carried out a comprehensive study of the active managers in the Morningstar database tracking two flagship EMD indices: JPM GBI-EM Global Diversified Index (GBI-EM) for local currency and JPM EMBI Global Diversified Index (EMBI) for hard currency. As illustrated in Figure 3, in both local and hard currency debt, while some active managers outperform their benchmarks, the majority have failed to do so over the longer term.

Figure 3: Percentage of Active Managers Who Fail To Outperform Benchmarks

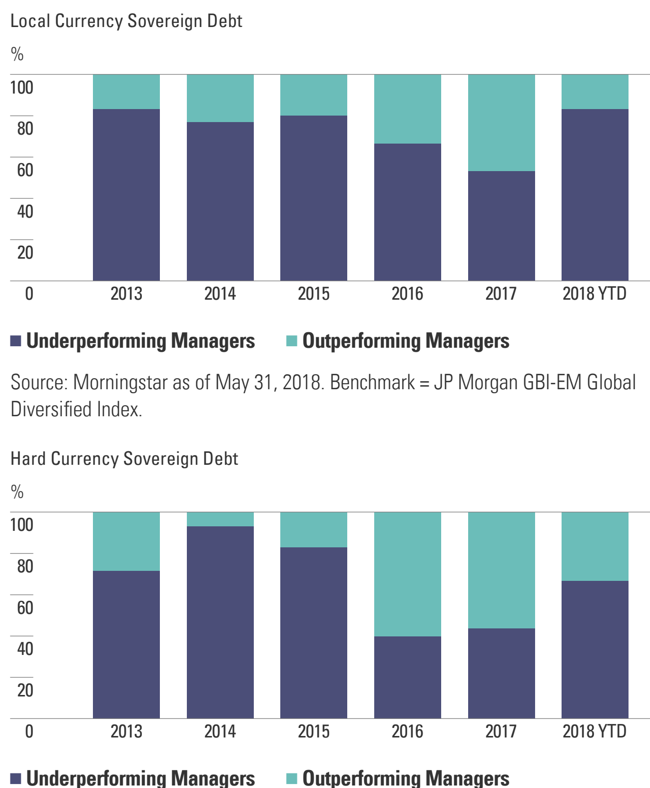
	1 year (%)	3 years (%)	5 years (%)
Local Currency Sovereign Universe	80	83	87
Hard Currency Sovereign Universe	50	57	83

Source: Morningstar. The universe is generated by selecting the 30 largest live funds as of May 31, 2018.

Outperforming the benchmark seems to be particularly challenging for active managers in the local currency universe. In 2017, just under half (47%) of the funds in our universe did manage to outperform the GBI-EM, but it was an exceptionally strong year for the asset class as a whole (Figure 4). In all the other years of the studied period, less than 25% of active managers outperformed. This shows us that underperformance is not the result of a single bad year or a one-off "Black Swan" event but rather a consistent and persistent problem.

Active managers in the hard currency sovereign universe have also struggled to outperform consistently as a group. While the strong performance of the market in 2016 and 2017 appears to have boosted active manager performance, half of all active

Figure 4: Active Manager Performance Over Discrete Years



Source: Morningstar as of May 31, 2018. Benchmark = JP Morgan GBI-EM Global Diversified Index.

Source: Morningstar as of May 31, 2018. Benchmark = JP Morgan EMBI Global Diversified.

managers underperformed in the year to May 2018 and, in the five years to end May 2018, a significant majority (83%) underperformed. These results raise the question about the ability of a typical active manager to outperform over the market cycle.

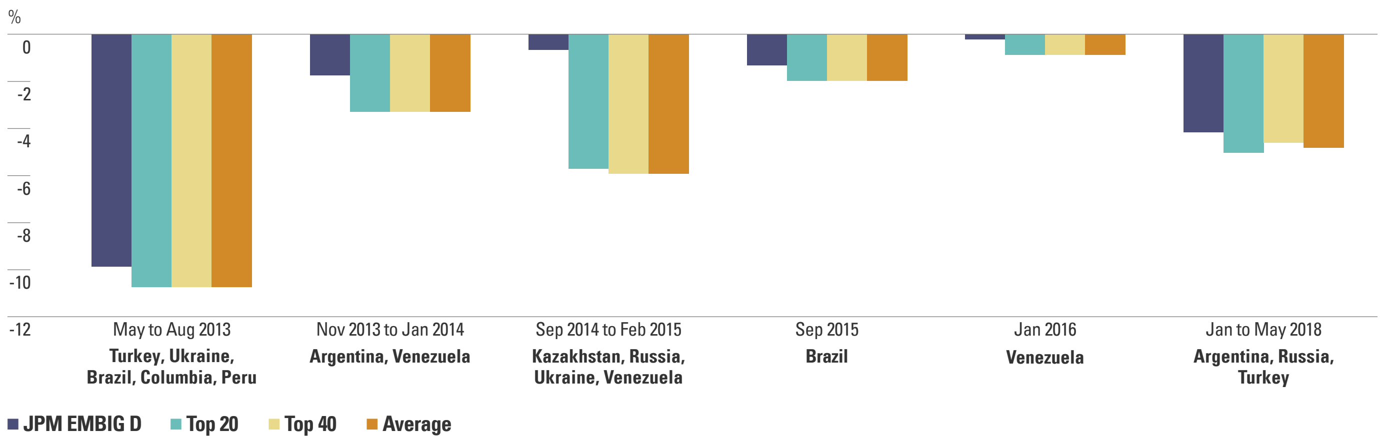
There is the semblance of a correlation between market underperformance and active manager underperformance. This is especially the case in the local currency universe where it often appears that the worse the performance of the index, the higher the percentage of active managers who underperform. In the hard currency universe, which is less volatile, active managers have typically done better. However, even here 71% of active managers underperformed in 2013 when the index fell -5.25%, while only 7% outperformed in 2014 when the EMBIG was up 7.43%. So strong market performance alone is not a guarantee of active manager success or sufficient downside protection.

DOWNSIDE PROTECTION

In our discussions with investors about EMD, it seems that, conceptually, they like the protection that a bottom-up, fundamentally-driven active approach should provide. After all, why should investors buy every issuer and country when some of them are unattractive from a fundamental risk/return profile? Unfortunately, our research does not support the idea that such approaches provide meaningful downside protection.

This is the case even in the hard currency universe where the diversified profile and absence of currency effects should create optimal conditions for active approaches to mitigate downside risk. We looked at six instances of significant negative return events in recent years driven by individual or multiple countries. In general, they were the result of a number of factors, including a sharply deteriorating economic outlook, political instability and debt restructuring. Some were perhaps easier to foresee (Venezuela, Ukraine) while others were more left-field (Russia, Brazil). In any event, either active managers were unable to predict these developments effectively or behavioural biases impacted their ability to manage these events profitably. As Figure 5 illustrates, even the top 20 managers were unable to outperform the index during these country-driven events.

Figure 5: Active Managers Struggle to Provide Downside Protection



Source: Morningstar as of May 31, 2018. Past performance is not a guarantee of future results.

WHY ACTIVE MANAGERS STRUGGLE TO OUTPERFORM

The inherently 'high-octane' and volatile nature of the EMD sector is likely to be one of the key causes of active manager underperformance. Returns are often misaligned with fundamentals, as they are driven by investor sentiment and political risk, which are harder to predict and often lead to binary outcomes. More specifically, active managers face different challenges in hard and local currency debt.

In hard currency debt, performance is often driven by high yield names in the index, as the investment grade names are already fairly priced and provide fewer opportunities for alpha generation. Importantly, within this high yield sub-index, it is often distressed names that determine whether a manger underperforms or outperforms the index. For example, in recent years, making the right calls on situations such as Argentina's litigation with holdout creditors, Ukraine's restructuring or Venezuela's willingness and ability to meet its debt obligations have been key to active manager performance. While many of these countries are only a small part of the index, being under or overweight them makes a big difference to performance, due to their high yield and the volatility of their returns.

By definition, these names are fundamentally weak and if a manager is driven by a quality-focused, bottom-up approach, they may miss the potential for sudden revivals. For instance, Venezuela has been thought of as a "basket case" for years, amid an ever worsening political and economic backdrop, but only announced a debt restructuring at the end of 2017. The year before that it actually delivered a staggering return of 53%. Had investors been consistently driven by fundamentals and been underweight the country, they would have incurred a significant "cost of carry." Although the country's average index weight has only been 1.74% in the three years to June 1, 2018, its average yield has been 32.2%. While many would have foreseen that a restructuring was on the cards for the troubled LatAm nation, getting the timing right would have been the key challenge. The many binary decisions active managers must take in the hard currency space may partly explain why they consistently struggle to outperform.

In local currency debt, the performance drivers are different: foreign exchange (FX) matters in the short term and local rates in the long term. EM currencies are typically the main adjustment valve to reflect market sentiment, which means that making the right call, especially in times of heightened market volatility, is particularly difficult.

Active managers must make a call between being underweight the currency of weaker but higher yielding countries, thereby incurring a significant cost of carry, or being overweight and facing the consequences if fortunes reverse, as they did this year. Local currency markets got off to a flying start in 2018, with the GBI-EM Index delivering a staggering return of 4.48% in January. But by the second quarter, markets had sold off sharply, delivering a return of -4.98% in May. In both cases performance was driven by FX which contributed 3.54% to returns in January and -3.62% in May. Contrary to what one might expect, being able to adjust to the rapidly changing macro backdrop has been hard for active managers.

Another potential explanation of active manager underperformance in both local and hard currency debt is that they may get stuck in value traps. For example, there is often more value in smaller issuers than bigger ones, partly due to the illiquidity premium of the former. Active managers target these pockets of illiquidity to generate alpha as these tend to produce stellar returns in a rallying market. However, the opposite is true during sell-offs and managers may find themselves inadvertently locked in when liquidity dries up. This is another potential explanation of why the drawdowns for active managers are typically much higher than the index during sell-offs.

DIVERSIFICATION AS A BULWARK

The nature of EM sell-offs is often event and sentiment driven, which makes them difficult to predict. Furthermore, restructuring cases, such as Ukraine and more recently Venezuela, can drag on for extended periods, providing significant carry along the way. A high degree of uncertainty combined with quite binary outcomes means that active managers have to gamble whether to be under or overweight, which may or may not pay off. Being neutral to the index is also an option, but that is not what they are paid to do. On the other hand, history shows that diversification can help mitigate potential credit events and a credit risk premium can be harvested across the overall diversified exposure to compensate for such events. Having broad index exposure appears to offer investors protection from some of the inherent behavioural biases of active managers and can provide higher return potential, despite offering exposure to both stronger and weaker parts of the universe.

An example which illustrates the importance of diversification is Nigeria and its removal from the GBI-EM Index. After the announcement was made, Nigeria defied all conventional wisdom and staged a strong rally before its actual exit date. This may have caught out many active investors who would typically have seen this as a signal to sell. If they liquidated their exposure before the actual removal of the country from the index, they would have incurred losses versus the index due to their underweight position. An index manager, however, is bound to replicate the country exposure of the index and would have benefitted from this situation.

INDEX STRATEGIES PROVIDE COST-EFFECTIVE SOLUTIONS

In the past, the high cost of replication, market volatility and inefficiency have been seen as the main obstacles to the use of index strategies in the EMD space. Although these concerns appear valid, indexing techniques have moved a long way from simply buying all the names in the index; there are practical steps that experienced investment managers can take to seek to minimise these negative effects. At State Street, we have been running indexed EMD strategies for 13 years and now have over US$ 23 billion in assets under management across local currency and hard currency debt, sovereigns and corporates. This investment expertise is evident in our consistent and efficient delivery of benchmark returns in indexed EMD strategies and funds.

These days, the cost of replication is no longer as prohibitive as many might expect. As we demonstrated in Figure 2, the trading cost for EM hard currency bonds is now comparable to investment grade corporate bonds, and the cost for local currency denominated securities is half that. When you marry this with an experienced, dedicated and co-located EMD trading desk, portfolio managers (PMs) are able to keep replication costs down.

Index turnover directly affects returns via rebalancing costs, and EMD indices typically experience higher levels of turnover than other fixed income benchmarks. Experienced and dedicated PMs are able to minimise turnover by pro-actively anticipating index changes, gaining exposure through primary market placements and working with their traders to access liquidity pools, with both well-known investment banks and local brokers. Examples of this include using the primary market to access illiquid markets prior to their inclusion in the index, managing this risk through the forward or non-deliverable forward market and ultimately delivering benchmark returns through a thoughtful but risk-controlled investment process. Managers like State Street are also able to capture structural risk premia that arise in the EMD market to offset costs.

Another feature of the space is that certain taxes are difficult to avoid when holding local EM bonds. However, a sophisticated investment management process that understands the risk/reward trade-offs between fully replicating the benchmark and alternative positions or proxies can minimise the tax drag without compromising on acceptable levels of risk. At State Street, we work with both the client and their custodians to get the most favourable tax status and to create strategies which reduce the tax impact.

Finally, indexed EMD strategies are not passive when it comes to portfolio construction and security selection. Experienced portfolio managers will consider market dynamics, liquidity and other factors when choosing securities in order to gain the required underlying exposure in the most effective and performance enhancing way.

SUMMARY

Over the last 15 years, the EMD sector has been transformed in terms of market size, liquidity and security type. The majority of active managers have persistently struggled with the volatile and changeable nature of EMD and have largely failed to provide either excess returns or downside protection. More cost-efficient and transparent index approaches are now being seen as highly effective and are gaining popularity among institutional investors. In the future, as emerging economies evolve further, EM bond exposures may become a core part of investors' fixed income portfolios. However, decisions as to what exposure to take and via which investing style will be paramount in determining whether the full potential benefits are realised.

Glossary

JP Morgan EMBIG Tracks dollar-denominated sovereign bonds issued by a selection of emerging market countries. The index limits the weights of countries with larger debt stocks by only including a specified portion of these countries' eligible current face amounts of debt outstanding.

JP Morgan GBIEM A comprehensive emerging market debt benchmark that tracks local currency bonds issued by emerging market governments.

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*AUM reflects approx. US$36B (as of March 31, 2018) with respect to which State Street Global Advisors Funds Distributors, LLC serves as marketing agent; SSGA FD, LLC and State Street Global Advisors are affiliated.

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Foreign investments involve greater risks than U.S. investments, including political and economic risks and the risk of currency fluctuations, all of which may be magnified in emerging markets.

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