Insights
Emerging Markets

October 2020

EMD Investing in the Aftermath of the COVID Crisis

Why Investors Should Consider Indexing for Hard Currency Allocation

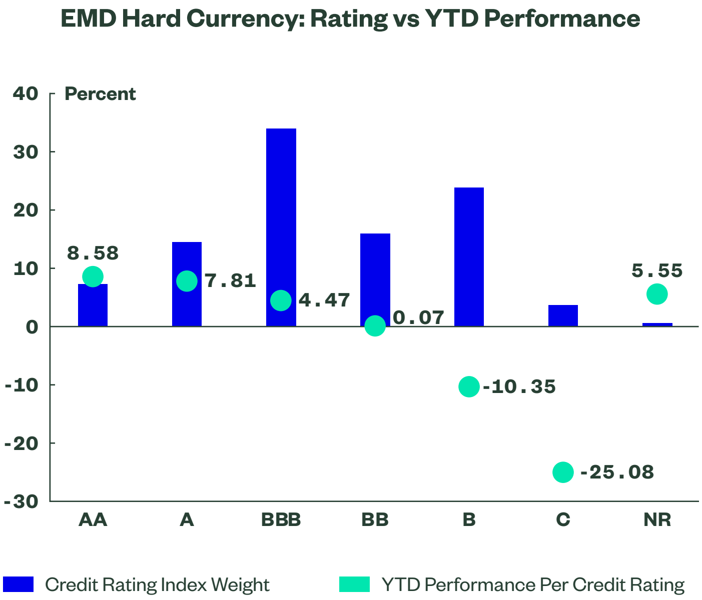
Lyubka Dushanova
Portfolio Specialist, Emerging Market Debt

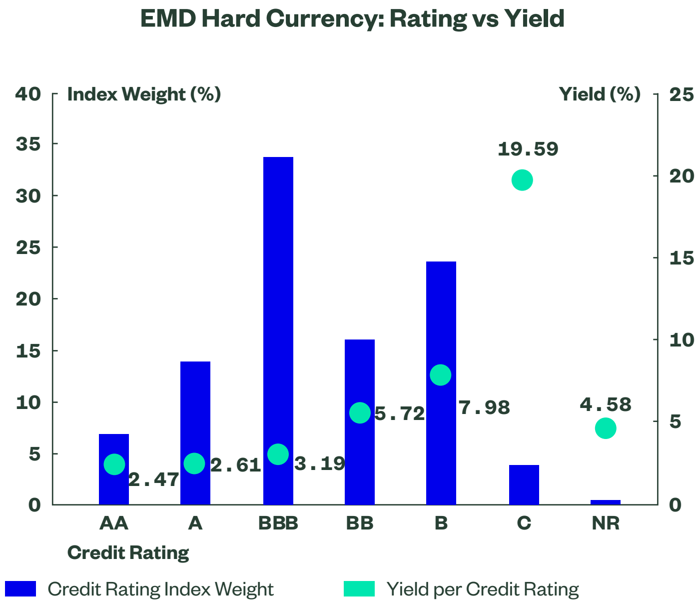
Emerging market hard currency sovereign debt presents a large and diversified investment universe with long-term upside potential. Often considered the domain of active managers, the reality is that many such managers in this asset class struggle to (1) outperform their benchmark in a consistent manner or (2) to protect capital during periods of drawdown — undermining the main rationale for investors traditionally choosing active approaches. Furthermore, the challenges that active hard currency managers face could be exacerbated by the COVID-19 induced crisis.

The idea of active management in Emerging Market Hard Currency Sovereign Debt is appealing. At first glance, this is an investment universe that offers plenty of opportunities for active managers to add value with the flagship JP Morgan EMBI Global Diversified (EMBIGD) index including 73 countries, 168 issuers and 847 bonds.[1] However, our research shows that the majority of active managers have struggled to outperform over the long term, and even more worrying for investors has been their inability to protect capital during periods of drawdown.[2] According to a study we conducted to the end of March 2020, 27 of the 30 largest managers in the Morningstar database benchmarked against the EMBIGD underperformed after fees over the five-year period. A closer inspection of the investment universe reveals some of the reasons why achieving outperformance versus the index can be challenging.

The EMD hard currency investment universe, as per JP Morgan's index, is comprised of 56% Investment Grade (IG) issuers and 44% High Yield (HY) issuers.[3] The IG part of the index attracts both dedicated emerging market debt investors and crossover investors due to its attractive yield, higher quality and better liquidity. Precisely because of these characteristics, however, this part of the investment universe is usually fairly priced and offers less opportunities for alpha creation. On the other hand, the HY part of the index by its nature is riskier and less liquid, but it is here where the opportunity set is often the greatest. Importantly, it is investments in the riskiest part of the index that can often make the difference between underperformance and outperformance for an active manager. For instance, at the end of September 2020, less than 4% of the index was in C-rated debt; however, with a yield of 19.6% and a return of -25.1% year-to-date, this portion of the index accounted for 0.72% of the overall index yield of 5.15% and detracted -0.93% from its year-to-date performance of -0.51%. This dichotomy highlights the key challenge that active managers in the asset class face — if a manager is underweight the riskier names, they run a high cost of carry; on the other hand, if they are overweight and their bets don't pan out as they expect, this can be the difference between outperformance and underperformance in a year.

Figure 1
Lower Quality Names in Index Account for Significant Part of Yield and Performance



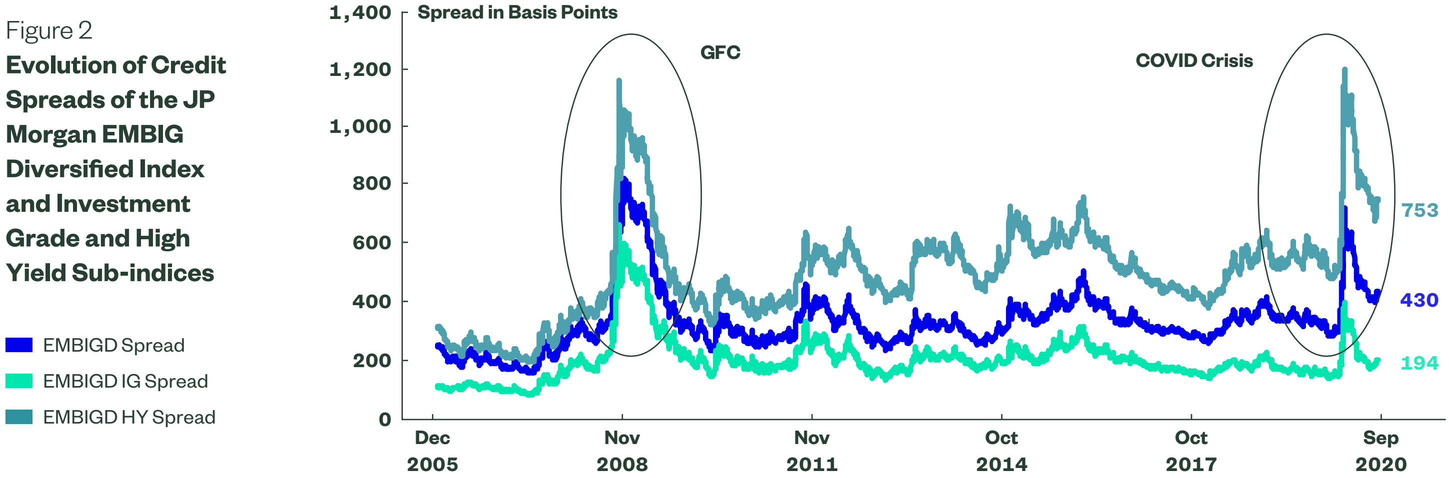


Source: State Street Global Advisors, JP Morgan as of 30 September 2020. EMD Hard Currency = JP Morgan EMBI Global Diversified. Past performance is not a reliable indicator of future performance.

Further Challenges for Active Managers in Aftermath of COVID-19 Crisis

The crisis induced by the COVID-19 pandemic could exacerbate further the challenges faced by active managers; in March 2020, hard currency sovereign debt sold off sharply, driven by the dual impact of the pandemic and the crash in oil prices. As a result, the EMBIGD spread widened to levels not seen since the Global Financial Crisis in 2008. The sell-off was across the board, affecting both HY and IG names — although the HY sub-index underperformed significantly. In the following months, as risk assets rebounded in response to aggressive monetary and fiscal stimulus in both emerging and developed markets, EM HY countries still lagged. This is not surprising, given that some countries in the EMD HY space are facing the very real risk of debt restructuring or default. However, the EMBIGD IG spread at 194bps on 2 October is already 8bps tighter than the 15-year average, suggesting there is little value left in the IG space. On the other hand, the spread of the HY sub-index at the same date was 753bps — this is 253bps wider than the 15-year average, indicating an opportunity with greater value potential.

Figure 2
Evolution of Credit Spreads of the JP Morgan EMBIG Diversified Index and Investment Grade and High Yield Sub-indices



Source: State Street Global Advisors, Bloomberg Finance LP, JP Morgan as of 2 October 2020. Past performance is a not a guarantee of future results..

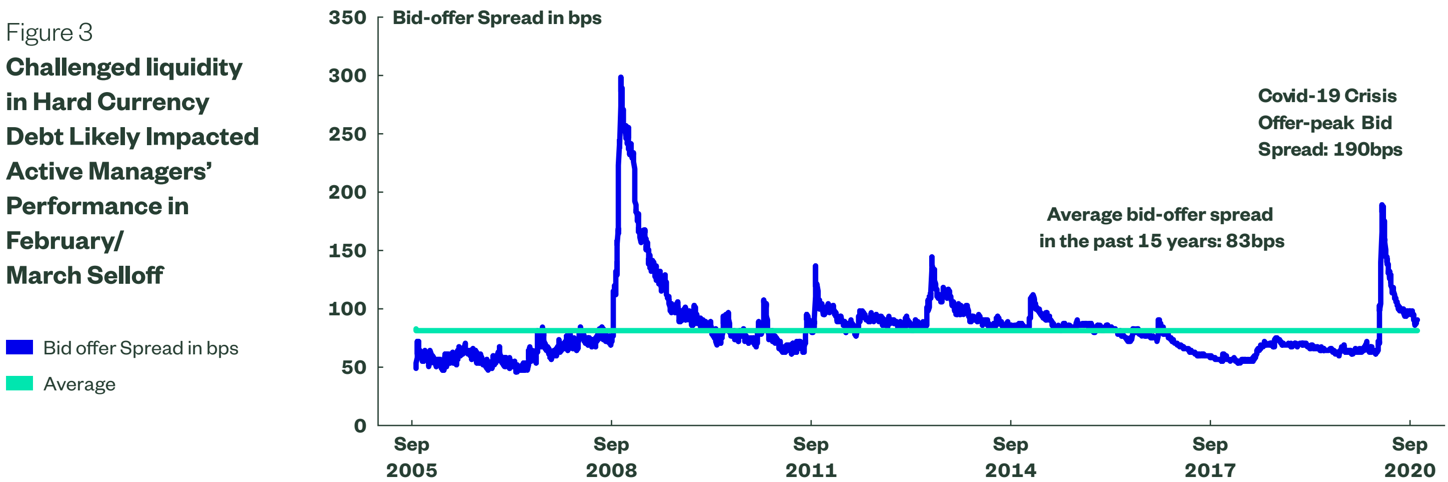
Debt Restructuring

Over the next couple of years, we are likely to see more restructurings in the EMD HY space as EM countries' ability and willingness to meet their debt obligations in the aftermath of the COVID-19 pandemic remain challenged. In 2020, we have already seen Argentina and Ecuador complete their debt restructuring, with Lebanon and Zambia next in line. Such situations are typically the playing field of managers of specialised distressed funds, the strategies of which often include lobbying governments and other bond holders. Active EM investors in the EMBIGD Index that are not specialists in this very niche field of distressed debt may struggle to get their bets right. Even if they have the necessary skillset, betting on distressed debt carries significantly more risk than a broader, diversified exposure to the EMBIGD Index.

Liquidity Considerations

Liquidity is also an important consideration. Based on analysis[4] we carried out, using the Morningstar database, during the market sell-off from mid-February to mid-March when the EMBIGD Index was down -12.25%, hard currency active managers underperformed the EMBIGD index by average of -3.39%, after fees. Local currency active managers underperformed it as well, but by a smaller amount: -1.3% on average after fees. The significantly greater underperformance of the hard currency active managers leads us to believe that liquidity was a contributing factor. Liquidity in both local and hard currency debt deteriorated during this period, though liquidity in EM Hard Currency debt deteriorated significantly more with the bid-offer spread of the EMBIGD index spiking by more than 100bps versus the 15-year average.

Figure 3
Challenged liquidity in Hard Currency Debt Likely Impacted Active Managers' Performance in February/ March Selloff



Source: State Street Global Advisors, JP Morgan at 30 September 2020. Past performance is a not a guarantee of future result.

Of the 30 largest active managers in the Morningstar database over the one-year period to March 2020, all but two of them had a beta greater than 1.0, indicating they were 'long' the market; the average beta was 1.20 and the median was 1.19. It is therefore possible that many active managers could have been 'trapped' in long positions going into the sell-off, with the lower-rated and less-liquid positions proving the most costly.

Given the challenges faced by active managers in EMD HC, we are of the view that investors who want to avoid the riskier names in this asset class are better off investing in an IG version of the index or in the ESG version of the index, which has an inherent quality bias. Investors that would like exposure to the full spectrum of risk and return that EM Hard Currency Sovereign Debt has to offer are arguably better to invest via an indexing strategy that offers diversified exposure across the universe rather than concentrated bets that may or may not pay off.

Indexing in EMD: Effective and Cost Efficient Approach to Capturing Potential in Hard Currency

Contrary to what seems to be a widely held belief among investors, EMD HC sovereign debt exposure can be delivered in an effective and cost-efficient way through indexing. While EMD HC debt has high structural costs of implementation because of the higher trading costs and the high turnover of the index, a skilful implementation of the index can overcome these costs and deliver or even outperform the index. For instance, based on our estimates, the cost of full replication of the flagship hard currency EMBIGD index in recent years has ranged between 10 and 18 basis points. A skilful implementation of the index can not only reduce significantly the cost of turnover and trading but also offset these costs partially or even fully by taking advantage of low risk alpha opportunities. Indeed, the diversified nature of the index offers ample such opportunities where a skilful index manager can take advantage of market dislocations and add incremental value without making fundamental bets and taking outsized risks.

This consistent and efficient delivery of EMD hard currency returns via indexing strategies is now challenging some of the well-established beliefs about how best to harness the long-term upside potential of EMD.

Glossary

Basis point One hundredth of one percent, or 0.01%.

Bid-Offer Spread The difference between the highest price a buyer is willing to pay for an asset and the lowest price the seller will accept to sell. Bid-offer spreads are a key measure of the liquidity of an asset or security.

Debt Restructuring An agreement that alters the terms previously established for repayment and may include rescheduling that revises the repayment schedule or the extending of a new refinancing loan.

Distressed Debt Refers to the securities of a government or company which has either defaulted or is in financial distress and moving towards potential default scenario.

Emerging Market Debt Bonds issued by governments or companies in developing countries.

Global Financial Crisis (GFC) The GFC refers to the period of extreme stress in financial markets and banking systems between mid-2007 and early-2009.

Hard Currency EMD Bonds issued by emerging market countries in currencies (such as the US dollar or euro) perceived as a more stable store of value.

High Yield Debt with generally lower credit ratings and higher yields than investment-grade bonds.

Investment Grade A fixed-income security that has a relatively low risk of default as determined by bond ratings firms.

Liquidity The ability to quickly buy or sell an investment in the market without impacting its price. Trading volume is a primary determinant of liquidity.

Local Currency EMD Bonds issued by emerging market countries in their own currencies.

Endnotes

1 Source: JP Morgan as of 2 October 2020.

2 Competitor analysis using the 30 largest funds in the Morningstar database with a track record of minimum five years benchmarked against the JP Morgan EMBI Global Diversified. Performance in US Dollars and net of fees as of 31 March 2020.

3 Source: JP Morgan as of 2 October 2020.

4 Competitor analysis based on the 30 largest funds in the Morningstar database, with a track record of minimum five years benchmarked against the JP Morgan EMBI Global Diversified. Performance in US Dollars and net of fees.

About State Street Global Advisors

For four decades, State Street Global Advisors has served the world's governments, institutions and financial advisors. With a rigorous, risk-aware approach built on research, analysis and market-tested experience, we build from a breadth of active and index strategies to create cost-effective solutions. As stewards, we help portfolio companies see that what is fair for people and sustainable for the planet can deliver long-term performance. And, as pioneers in index, ETF, and ESG investing, we are always inventing new ways to invest. As a result, we have become the world's third-largest asset manager with US $3.05 trillion* under our care.

* This figure is presented as of June 30, 2020 and includes approximately $69.52 billion of assets with respect to SPDR products for which State Street Global Advisors Funds Distributors, LLC (SSGA FD) acts solely as the marketing agent. SSGA FD and State Street Global Advisors are affiliated.

ssga.com

State Street Global Advisors Worldwide Entities

Abu Dhabi: State Street Global Advisors Limited, ADGM Branch, Al Khatem Tower, Suite 42801, Level 28, ADGM Square, Al Maryah Island, P.O Box 76404, Abu Dhabi, United Arab Emirates. Regulated by the ADGM Financial Services Regulatory Authority. T: +971 2 245 9000. **Australia:** State Street Global Advisors, Australia, Limited (ABN 42 003 914 225) is the holder of an Australian Financial Services License (AFSL Number 238276). Registered office: Level 14, 420 George Street, Sydney, NSW 2000, Australia. T: +612 9240-7600. F: +612 9240-7611. **Belgium:** State Street Global Advisors Belgium, Chaussée de La Hulpe 120, 1000 Brussels, Belgium. T: 32 2 663 2036. F: 32 2 672 2077. SSGA Belgium is a branch office of State Street Global Advisors Ireland Limited. State Street Global Advisors Ireland Limited, registered in Ireland with company number 145221, authorised and regulated by the Central Bank of Ireland, and whose registered office is at 78 Sir John Rogerson's Quay, Dublin 2. **Canada:** State Street Global Advisors, Ltd., 1981 McGill College Avenue, Suite 500, Montreal, Qc, H3A 3A8, T: +514 282 2400 and 30 Adelaide Street East Suite 800, Toronto, Ontario M5C 3G6. T: +647 775 5900. **France:** State Street Global Advisors Ireland Limited, Paris branch is a branch of State Street Global Advisors Ireland Limited, registered in Ireland with company number 145221, authorised and regulated by the Central Bank of Ireland, and whose registered office is at 78 Sir John Rogerson's Quay, Dublin 2. State Street Global Advisors Ireland Limited, Paris Branch, is registered in France with company number RCS Nanterre 832 734 602 and whose office is at Immeuble Défense Plaza, 23-25 rue Delarivière-Lefoullon, 92064 Paris La Défense Cedex, France. T: (+33) 1 44 45 40 00. F: (+33) 1 44 45 41 92. **Germany:** State Street Global Advisors GmbH, Brienner Strasse 59, D-80333 Munich. Authorised and regulated by the Bundesanstalt für Finanzdienstleistungsaufsicht ("BaFin"). Registered with the Register of Commerce Munich HRB 121381. T: +49 (0)89-55878-400. F: +49 (0)89-55878-440. **Hong Kong:** State Street Global Advisors Asia Limited, 68/F, Two International Finance Centre, 8 Finance Street, Central, Hong Kong. T: +852 2103-0288. F: +852 2103-0200. **Ireland:** State Street Global Advisors Ireland Limited is regulated by the Central Bank of Ireland. Registered office address 78 Sir John Rogerson's Quay, Dublin 2. Registered Number: 145221. T: +353 (0)1 776 3000. F: +353 (0)1 776 3300. **Italy:** State Street Global Advisors Ireland Limited, Milan Branch (Sede Secondaria di Milano) is a branch of State Street Global Advisors Ireland Limited, registered in Ireland with company number 145221, authorised and regulated by the Central Bank of Ireland, and whose registered office is at 78 Sir John Rogerson's Quay, Dublin 2. State Street Global Advisors Ireland Limited, Milan Branch (Sede Secondaria di Milano), is registered in Italy with company number 10495250960 - R.E.A. 2535585 and VAT number 10495250960 and whose office is at Via Ferrante Aporti, 10 - 20125 Milano, Italy. T: +39 02 32066 100. F: +39 02 32066 155. **Japan:** State Street Global Advisors (Japan) Co., Ltd., Toranomon Hills Mori Tower 25F 1-23-1 Toranomon, Minato-ku, Tokyo 105-6325 Japan. T: +81-3-4530-7380. Financial Instruments Business Operator, Kanto Local Financial Bureau (Kinsho #345), Membership: Japan Investment Advisers Association, The Investment Trust Association, Japan, Japan Securities Dealers' Association. **Netherlands:** State Street Global Advisors Netherlands, Apollo Building, 7th floor Herikerbergweg 29 1101 CN Amsterdam, Netherlands. Telephone: 31 20 7181701. SSGA Netherlands is a branch office of State Street Global Advisors Ireland Limited, registered in Ireland with company number 145221, authorised and regulated by the Central Bank of Ireland, and whose registered office is at 78 Sir John Rogerson's Quay, Dublin 2. **Singapore:** State Street Global Advisors Singapore Limited, 168, Robinson Road, #33-01 Capital Tower, Singapore 068912 (Company Reg. No: 200002719D, regulated by the Monetary Authority of Singapore). T: +65 6826-7555. F: +65 6826-7501. **Switzerland:** State Street Global Advisors AG, Beethovenstr. 19, CH-8027 Zurich. Authorised and regulated by the Eidgenössische Finanzmarktaufsicht ("FINMA"). Registered with the Register of Commerce Zurich CHE-105.078.458. T: +41 (0)44 245 70 00. F: +41 (0)44 245 70 16. **United Kingdom:** State Street Global Advisors Limited. Authorised and regulated by the Financial Conduct Authority. Registered in England. Registered No. 2509928. VAT No. 5776591 81. Registered office: 20 Churchill Place, Canary Wharf, London, E14 5HJ. T: 020 3395 6000. F: 020 3395 6350. **United States:** State Street Global Advisors, One Iron Street, Boston, MA 02210-1641. T: +1 617 786 3000.

The information provided does not constitute investment advice as such term is defined under the Markets in Financial Instruments Directive (2014/65/EU) and it should not be relied on as such. It should not be considered a solicitation to buy or an offer to sell any investment. It does not take into account any investor's or potential investor's particular investment objectives, strategies, tax status, risk appetite or investment horizon. If you require investment advice you should consult your tax and financial or other professional advisor. All information is from State Street Global Advisors unless otherwise noted and has been obtained from sources believed to be reliable, but its accuracy is not guaranteed. There is no representation or warranty as to the current accuracy, reliability or completeness of, nor liability for, decisions based on such information and it should not be relied on as such.

Past performance is not a reliable indicator of future performance. Index returns are unmanaged and do not reflect the deduction of any fees or expenses.

Diversification does not ensure a profit or guarantee against loss.

Investing involves risk including the risk of loss of principal.

The views expressed in this material are the views of Lyubka Dushanova through the period ended 30 September 2020 and are subject to change based on market and other conditions. This document contains certain statements that may be deemed forward-looking statements. Please note that any such statements are not guarantees of any future performance and actual results or developments may differ materially from those projected.

The information contained in this communication is not a research recommendation or 'investment research' and is classified as a 'Marketing Communication' in accordance with the Markets in Financial Instruments Directive (2014/65/EU) or applicable Swiss regulation. This means that this marketing communication (a) has not been prepared in accordance with legal requirements designed to promote the independence of investment research (b) is not subject to any prohibition on dealing ahead of the dissemination of investment research.

Bonds generally present less short-term risk and volatility than stocks, but contain interest rate risk (as interest rates raise, bond prices usually fall); issuer default risk; issuer credit risk; liquidity risk; and inflation risk. These effects are usually pronounced for longer-term securities. Any fixed income security sold or redeemed prior to maturity may be subject to a substantial gain or loss.

Investing in foreign domiciled securities may involve risk of capital loss from unfavourable fluctuation in currency values, withholding taxes, from differences in generally accepted accounting principles or from economic or political instability in other nations. Emerging or developing markets may be more volatile and less liquid than investing in developed markets and may involve exposure to economic structures that are generally less diverse and mature and to political systems which have less stability than those of more developed countries.

The trademarks and service marks referenced herein are the property of their respective owners. Third party data providers make no warranties or representations of any kind relating to the accuracy, completeness or timeliness of the data and have no liability for damages of any kind relating to the use of such data.

ID313717-3268456.1.1.GBL.RTL 1020
Exp. Date: 31/10/2021