

# EMD Local Currency: Not All Indices Are the Same

## SPDR EMEA ETF Strategy Team

Index rules vary from one provider to the other. In some cases this variance could lead to differences in the interpretation or definition of certain regions.

In the fixed income space, and emerging market debt in particular, there are different approaches to country inclusion rules. For investment vehicles like ETFs, understanding this difference can in turn present opportunities when using a fund that follows one index or another.

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This paper compares and contrasts the index construction approach of Bloomberg Barclays and JP Morgan as it pertains to emerging market debt (EMD) indices tracked by ETFs in Europe. The focus is on the two indices most representative of the assets invested in European-domiciled ETFs, as they comprise close to 95% of assets with circa \$10.1 billion.<sup>1</sup>

- Within EMD indices, there are various methodologies for determining country inclusions; JP Morgan, in particular, created a range of custom indices that introduce pre-determined 'floors' (i.e. a minimum weight within the index) and 'caps' (a maximum weight within the index) for their constituents. These differences can result in substantially different index performance.
- In terms of investment universe, the Bloomberg Barclays Emerging Markets Local Currency Liquid Government Bond Index has a greater number of constituent (543 bonds) than its JP Morgan counterpart, thus providing a broader pool of securities in which to invest. This is an important consideration, especially for investors who may be concerned about fund sizes, market impact and liquidity constraints.

<sup>1</sup> Bloomberg Finance L.P., as of 31 March 2020.

## Inclusion Rules: Countries

Figure 1  
**Summary of Country  
Inclusion Rules**  
Bloomberg Barclays vs.  
JP Morgan Index

	<b>Bloomberg Barclays Emerging Markets Local Currency Liquid Government Bond Index</b>	<b>JP Morgan GBI-EM Global Diversified 10% Cap &amp; 1% Floor</b>
Emerging Market Country Definition & Country Eligibility	Bloomberg Barclays uses a fixed list of emerging market countries that is reviewed annually to define country eligibility in dedicated EM hard currency, local currency and inflation-linked benchmarks. Criteria for inclusion in the EM country list are rules based and include: <ul style="list-style-type: none"> <li>Countries that meet one of the following two criteria: World Bank Income group classifications of low/middle income OR International Monetary Fund (IMF) classification as a non-advanced country.</li> </ul>	For a country to be eligible for inclusion in the JP Morgan GBI-EM indices, GNI per capita must be below the Index Income Ceiling (IIC) for three consecutive years. JP Morgan defines the IIC as the GNI per capita level that is adjusted every year by the growth rate of the World GNI per capita, Atlas method (current US\$), provided by the World Bank annually. An existing country may be considered for removal from the index if its GNI per capita is above the IIC for three consecutive years and its long-term local sovereign credit rating (the available rating agencies: S&P, Moody's & Fitch) is A-/A3/A- or above for three consecutive years.
Additional Criteria	In addition to being defined as an Emerging Market under Bloomberg Barclays EM country definition, inclusion in the EM Local Currency Liquid Government Bond Index is also based on market size and an evaluation of market investability. The maximum weight of a country is capped at 10% based on market cap.	The JP Morgan GBI EM Global Diversified 10% Cap & 1% Floor Index does NOT include markets with capital controls. The maximum weight of a country is capped at 10% based on market cap. The minimum weight of a country is 1% based on issue amount outstanding. New markets require a weight of at least 1% in the flagship GBI-EM Global Diversified.
EM Country list	EM country list is evaluated once a year during the Barclays annual index governance process.	—
Recent Index Changes	China added (April 2019), Argentina removed (September 2019)	Argentina removed (November 2019)

Source: State Street Global Advisors, Bloomberg Finance L.P., JP Morgan, as of 31 March 2020.

## Country Rules Impact on Index Composition

The difference in emerging market definitions will lead to differences in countries between the Bloomberg Barclays and JP Morgan index families.

Figure 2  
**Summary of Key Index  
Characteristics**

	<b>Bloomberg Barclays Emerging Markets Local Currency Liquid Government Bond Index</b>	<b>JP Morgan EM-GBI Global Diversified 10% Cap 1% Floor Index</b>
Inception Date	30 - Jun - 08	28 - Feb - 17
Number of Countries	19	15
Number of Constituents	543	218
Coupon Par Weighted	5 . 12	5 . 85
Yield to Worst	4 . 38	5 . 21
OAD	6 . 22	5 . 39
OAC	0 . 82	0 . 5
Maturity	8 . 76	7 . 52
Index Rating	A3/BAA1	BAA1/BAA2

Source: State Street Global Advisors, Bloomberg Finance L.P., JP Morgan, as of 31 March 2020. Data are as of the date indicated, subject to change, and should not be relied upon as current thereafter. The index rating is the middle rating of the three main rating agencies S&P, Moody's and Fitch.

## Country Distribution

Index rules will have an impact on country membership, bonds that are included in each country, and market valuations. Within countries, the difference will also come from the types of bonds included.

In the Philippines, the Bloomberg Barclays index includes both international and domestic bonds, while the JP Morgan no longer provides exposure to Philippines due its inclusion criteria.

In April 2019, Bloomberg began the integration of China into its index. Chinese government bonds are being added to the index at a rate of 0.5% per month for a period of 20 months. The final weight of China in the index will be approximately 10%, which is the country weight cap for the Bloomberg index. China is being added to the JP Morgan index at a pace of 1% per month from the end of March 2020.

Figure 3  
Country Distribution

	Bloomberg Barclays EM Local Currency Liquid Government Bond Index		JP Morgan EM-GBI Global Diversified 10% Cap 1% Floor Index	
	Market Value (%)	# Constituents	Market Value (%)	# Constituents
<b>Total</b>	<b>100</b>	<b>543</b>	<b>100</b>	<b>218</b>
Israel	3.96	14	–	–
South Africa	4.87	13	8.17	12
China	6.50	149	–	–
Indonesia	8.56	41	10.00	28
Malaysia	9.02	63	6.49	24
Philippines	3.35	26	–	–
South Korea	10.00	50	–	–
Thailand	8.87	27	9.99	17
Czech Republic	2.66	12	4.33	11
Hungary	2.09	13	3.88	11
Poland	6.49	17	10.00	14
Romania	2.01	16	3.11	12
Russia	4.89	22	8.49	21
Turkey	2.43	21	3.54	15
Mexico	8.01	16	10.00	16
Argentina	–	–	–	–
Brazil	9.80	16	10.00	12
Chile	1.50	7	2.73	5
Colombia	2.90	10	5.32	11
Peru	2.08	10	3.95	9

Source: State Street Global Advisors, Bloomberg Finance L.P., JP Morgan, as of 31 March 2020. Data are as of the date indicated, subject to change, and should not be relied upon as current thereafter.

Figure 4  
**Country Weights  
 Drive Average  
 Quality Differences**

	Bloomberg Barclays EM Local Currency Liquid Government Bond Index			JP Morgan EM-GBI Global Diversified 10% Cap 1% Floor Index		
	Market Value (%)	Index Rating	Index Rating Number	Market Value (%)	Index Rating	Index Rating Number
<b>Total</b>	<b>100</b>	<b>A3/BAA1</b>	<b>9</b>	<b>100</b>	<b>BAA1/BAA2</b>	<b>10</b>
Israel	3.96	A1	6	–	–	–
South Africa	4.87	BA1	12	8.17	BA1	12
China	6.50	A1	6	–	–	–
Indonesia	8.56	BAA2	10	10.00	BAA2	10
Malaysia	9.02	A3	8	6.49	A3	8
Philippines	3.35	BAA2	10	–	–	–
South Korea	10.00	AA2	4	–	–	–
Thailand	8.87	BAA1	9	9.99	BAA1	9
Czech Republic	2.66	AA3	5	4.33	AA3	5
Hungary	2.09	BAA2	10	3.88	BAA2/BAA3	10
Poland	6.49	A2	7	10.00	A2/A3	7
Romania	2.01	BAA3	11	3.11	BAA3	11
Russia	4.89	BAA2	10	8.49	BAA2	10
Turkey	2.43	BA3	14	3.54	BA3/B1	14
Mexico	8.01	BAA1	9	10.00	BAA1/BAA2	9
Argentina	–	–	–	–	–	–
Brazil	9.80	BA3	14	10.00	BA3	14
Chile	1.50	A1	6	2.73	A1	6
Colombia	2.90	BAA2	10	5.32	BAA2	10
Peru	2.08	A3	8	3.95	A3	8

Source: State Street Global Advisors, Bloomberg Finance L.P., JP Morgan, as of 31 March 2020. Data are as of the date indicated, subject to change, and should not be relied upon as current thereafter. The index rating is the middle rating of the three main rating agencies S&P, Moody's and Fitch.

That focus on a restricted subset of securities reduces the potential for diversification and, combined with potential floors in the case of JP Morgan GBI-EM Global Diversified 10% Cap 1% Floor index, could create liquidity pressures.

In terms of investment universe, the Bloomberg Barclays index has a greater number of constituents (more than 540 bonds), thus providing a broader pool of securities in which to invest. This is an important consideration, especially for investors who may be concerned about fund sizes, market impact, and liquidity constraints.

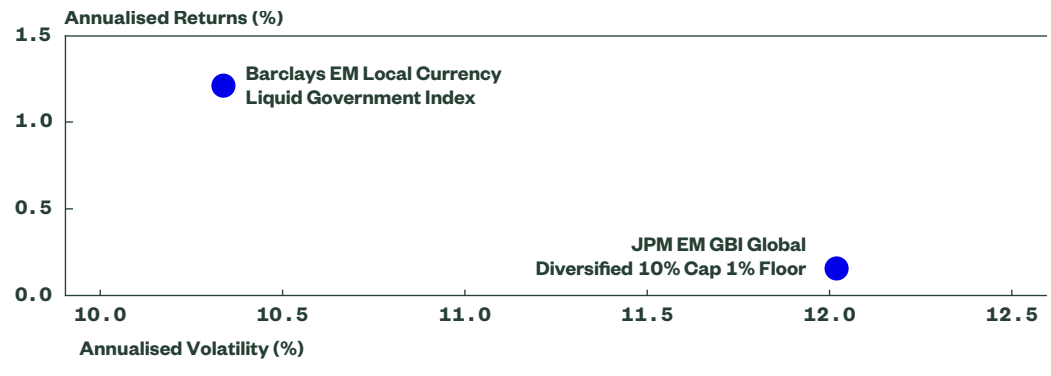
As a consequence of the index inclusion rules, the number of bonds and the market value of the indices will vary. The difference between the two local currency EM debt indices will come from the countries included as well as the bonds included in each index. Moreover, the JP Morgan GBI-EM Diversified Index methodology uses only a limited portion of a country's current face amount outstanding for calculating weights (see JP Morgan Index rules and methodology for further details).

The nature of the 1% nominal floor and 10% market cap rules of the JP Morgan index drive, to an extent, the weights of countries towards the 10% cap (e.g. Poland or Indonesia). The floor creates much higher weights for smaller countries where the same bonds are included, such as Peru (3.95% vs. 2.1% in the Bloomberg Barclays index). This can be called a small cap bias, and it could lead to questions concerning liquidity.

## Diversification and Risk-Adjusted Returns

The Bloomberg Barclays EM Local Currency Liquid Government Index has, over time, exhibited a better risk-adjusted profile than that of the JP Morgan GBI-EM Global Diversified 10% Cap 1% Floor index. This is in part due to the inclusion of South Korea and Israel in the Bloomberg Barclays universe. In Figure 5, we plot the risk return of the Bloomberg Barclays EM Local Currency Liquid Government Index and the JP Morgan EM-GBI Global Diversified 10% Cap 1% Floor.

Figure 5  
Five-Year Annualised Risk Return in USD Unhedged



Source: Bloomberg Finance L.P., as of 31 March 2020. **Past performance is no guarantee of future results. It is not possible to invest directly in an index. Index performance does not reflect charges and expenses associated with the fund or brokerage commissions associated with buying and selling a fund. Index performance is not meant to represent that of any particular fund.**

Figure 6  
Annualised Performance & Volatility in USD Unhedged

	Annualised Return (%)			Annualised Volatility (%)			Sharpe Ratio		
	Barclays EM Local Currency Liquid Government Index	JPM EM GBI Global Diversified 10% Cap 1% Floor	JPM EM GBI Global Diversified	Barclays EM Local Currency Liquid Government Index	JPM EM GBI Global Diversified 10% Cap 1% Floor	JPM EM GBI Global Diversified	Barclays EM Local Currency Liquid Government Index	JPM EM GBI Global Diversified 10% Cap 1% Floor	JPM EM GBI Global Diversified
Last 12 Months	-3.65	-7.31	-6.52	12.47	14.98	14.82	-0.47	-0.63	-0.58
Last 3 Years	0.75	-1.15	-0.80	9.59	11.73	11.55	-0.12	-0.26	-0.23
Last 5 Years	1.20	0.13	0.25	10.34	12.02	11.99	-0.01	-0.10	-0.09

Source: State Street Global Advisors, Bloomberg Finance L.P., JP Morgan, as of 31 March 2020. Risk-free rate based on JP Morgan 1M USD Cash index. The JP Morgan EM-GBI Global Diversified 10% Cap 1% Floor index was inception on 28 February 2017. Results prior to this date were calculated by using available data at the time in accordance with the Index's current methodology. **Past performance is no guarantee of future results. It is not possible to invest directly in an index. Index performance does not reflect charges and expenses associated with the fund or brokerage commissions associated with buying and selling a fund. Index performance is not meant to represent that of any particular fund.**

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## Summary

Understanding the key differences between emerging market local currency indices is important as they drive the overall characteristics of the ETF benchmarked against them. In turn, the differing characteristics will also affect the overall risk-return profile of the ETF, so investors should consider these factors carefully when selecting the ETF most appropriate to their investment objectives.

State Street Global Advisors' size, scale and experience in the emerging market local currency debt space mean that we can accommodate the needs of clients whose specific objectives cannot be met by a general index; we would be happy to discuss your options as necessary.

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## Key Risks

**Government default** There is still always the chance that governments can default on their debt. In that event, governments may not be able to meet their obligations and investors could lose the value of their investment.

**Geopolitical risk** Emerging market countries can at times be less stable than their developed market counterparts. Any disruption to the governments or financial markets in emerging markets can have an impact on how effectively governments can service their debt.

**Market uncertainty** Emerging market debt performance is driven by interest rates and credit spreads. Thus any significant moves in these factors can have an impact (positive or negative) on the value of this asset class.

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