Many institutional investors have embraced emerging market debt (EMD) as a potential source of diversified and attractive returns. Emerging markets now account for more than half of global GDP and are generally less indebted than developed markets (Figure 1). The global asset class is over $14 trillion in size and offers the potential for attractive diversification, yield advantages over developed markets debt of equivalent quality, and inefficiencies that could be captured by active management.

Figure 1: Emerging markets often have better fundamentals than developed markets

Dispersion and Adverse Selection
Since the global financial crisis and the end of the commodity-driven growth boom, however, the defining characteristic of emerging markets has become vast regional, economic and political dispersion. The emerging capital markets are globally inter-related yet inconsistent in their development. Such variations provide opportunities for successful active management, but they also highlight the weakness of traditional market-capitalization-weighted bond indices. These indices typically reflect the total issuance of debt across sectors, exposing portfolios to the countries and industries that borrow the most, rather than more financially secure issuers that borrow less. These adverse selection challenges are no less pronounced in EMD.

As the asset class has evolved and institutional investment has increased, managers have expanded their capabilities but still typically offer distinct sovereign, credit and local currency portfolios. More recent trends involve strategies that blend indices but do not materially shift the dynamics that challenge index-based strategies. Often active managers still express overweights and underweights versus an index and do not holistically evaluate the EMD opportunity set and the interrelated components.

In this environment, we believe that by stepping completely away from a benchmark-oriented portfolio strategy, managers can eliminate unintentional risk exposures and correlations, leaving a more positive opportunity profile.

THE CASE FOR A NEW APPROACH TO EMD

A strategy unconstrained by a benchmark can seek the best possible return with an eye toward downside protection. It is distinguished from a relative return approach, in which the portfolio anchors itself to a traditional benchmark and attempts to beat that benchmark through the use of overweights and underweights.
We believe that investing with a focus on best ideas, incorporating downside protection, is more likely to deliver sustainable positive outcomes. We advocate an approach with the following characteristics:

- **Invests only in the best ideas:** Being unconstrained and benchmark agnostic, a manager is free to invest in the ideas with potentially the most attractive risk/reward profiles from across the EMD universe while excluding those that do not fit.
- **Actively blends asset allocation across the EMD universe:** A portfolio should reflect an understanding of the interdependence and cross-correlations in the real world of emerging economies. Such strategies can take into account the relative risk/reward profile of all EMD instruments, blending inter- and intra-country exposures across USD and local currency-denominated sovereign and corporate debt, aiming to take advantage of the strengths of each while gaining diversification and risk-mitigation benefits from their relationships.
- **Focuses on return drivers:** A strategy should benefit from detailed analysis of the factors that affect performance within complex markets, enabling the portfolio to focus on intended risk exposures that reflect the many positive return drivers within EMD, while avoiding exposures that do not contribute.
- **Expresses negative views through short positions:** The ability to hold short positions could help a strategy to generate positive returns from the widest possible opportunity set. Interest rates and currencies can rise or fall as different countries’ fortunes improve or deteriorate. Some of the 90+ emerging countries will inevitably be passing through a deteriorating stage of the interest rate and credit cycle. Short positions can enable strategies to benefit in various circumstances.²
- **Seeks to preserve capital:** By avoiding or actively shorting deteriorating credits and countries, active managers can protect and balance the portfolio, avoiding large drawdowns while participating in the upside. Capital preservation techniques could lead to a more robust portfolio that can be skewed to capture upside when conditions are favorable and get net short when conditions are poor.

We believe the range of investment tools available in such an approach to EMD allows for significantly better upside capture and downside protection compared to a traditional long-only strategy.

### PORTFOLIO IMPLEMENTATION: EXPOSURES AND TIMING

- **Resilience:** A portfolio that consists of both long and short positions helps to build in sufficient flexibility to reposition when the economic, rate or currency cycle reverses, which should make it more robust in response to market shocks. This could help mitigate investor concerns about timing and volatility that come with investing in traditional EMD strategies. In our opinion, such an approach is particularly suited to EMD because it has sufficient complexity, volatility and amplitude to generate attractive returns.
- **Lower timing risk:** In a traditional EMD strategy, returns are historically driven by the astute or lucky timing of new investments, as outsized gains typically follow allocations made right after a market trough. Once market corrections have adjusted, subsequent investments may not realistically replicate these large gains. Although institutional investors may hold off on new EMD allocations until an appealing entry point appears, those times are often the most difficult moments to invest because the news flow is overwhelmingly negative. In contrast, we believe benchmark-unconstrained strategies are more nimble and less exposed to new investment timing risk. Combinations of long and short positions help could help reduce the importance of timing the entry just right, and cash collateral helps keeps powder dry to benefit when markets reprice or interest rates rise.
- **Time horizon:** The time horizon of such a strategy can be notably different than a traditional portfolio. Typical benchmark-driven portfolios aim to outperform the index over a full market cycle, which may be between three and five years. In contrast, an unconstrained strategy can seek to deliver a positive return over a 12-month horizon. By positively skewing the risk/reward profile, the portfolio could maintain the potential for upside even in down markets.
- **Ability to hedge out unwanted risks:** Traditional EMD index exposures have multiple building blocks that include significant exposure to the interest rate risk of US treasuries and the US dollar. Index-based strategies will be meaningfully correlated with core developed market investment-grade fixed income. Unconstrained strategies, on the other hand, can hedge out unwanted risks such as those correlated with developed market rates. By targeting favorable exposures and eliminating unintentional risks, unconstrained strategies potentially offer better risk mitigation within a portfolio.
- **Larger allocations:** Because traditional strategies rely exclusively on diversification to minimize the downside risk of the inevitable losing investments, they are forced to limit their exposures even to the best ideas. And because allocations are sized for higher volatility, the exposure is often smaller than the opportunity set deserves. The more sophisticated investment tools available to unconstrained strategies allow them to access a fuller set of opportunities. We believe larger portfolio allocations to EMD make sense.

² It is common to restrict portfolios from selling physical securities. Short exposures are typically expressed through credit default swaps, interest rate swaps and FX.

No investment strategy or risk management technique can guarantee performance or eliminate risk in any market environment.
INVESTING IN EMD TODAY

Today, global markets are distorted by policymakers seeking to spur reflation and global growth via unprecedented monetary experimentation – negative real interest rates combined with quantitative easing – and emerging markets are bearing some of the unintended consequences of these policies.

• **Current conditions**: We believe an adjustment is currently underway with the potential to trigger shocks through too much debt, the end of quantitative easing, foreign exchange shifts and overall credit deterioration. Under these market conditions, it is important for institutional investors to seek out strategies that avoid indiscriminate exposures, skew to the appreciating opportunities and eliminate exposures most likely to face accidents. Figure 2 shows both the size of the EMD opportunity and the range of investment and spreads available.

• **A strong dollar**: US dollar strength has also created significant headwinds for traditional EMD strategies that are forced to replicate benchmark exposures. In contrast, a benchmark-unconstrained EMD approach maintains the ability to express short positions in EM FX or in issues that are vulnerable to a strong dollar, enabling investors to benefit if the USD continues to strengthen. Once the dollar strengthening trend has run its course, an unconstrained manager can tactically change exposure in response.

Figure 2: Why have investors sought EMD exposure?

Source: BAML and JP Morgan as of December 31, 2015. Area of bubble = size of market, e.g. size of EM Corporates market = $1.4 trillion.

The emerging markets span 90 countries across multiple continents. Emerging market debt has six sub-asset classes:

- External government debt
- External corporate debt
- Local currency government bonds
- Local currency corporates
- Currency
- Derivatives

We believe that active management should evaluate all the relationships, isolate the most compelling investments and avoid unintended exposures.

THE IMPORTANCE OF A GROWING TOOLSET

A critical element of a benchmark-unconstrained strategy is the toolset, which creates access to the broadest opportunity set across all markets. As economies grow, their debt markets deepen. And as economies develop their capital markets, they increase the type and liquidity of instruments available in portfolio strategies, such as the use of derivatives and the ability to short exposures in those markets where derivatives markets are sufficiently liquid.

The opportunities for investors are many and varied (see Figure 3). There are currently seven emerging markets with a fully developed range of capital market instruments, including interest rate swap and foreign exchange options, and there are 32 emerging markets with at least four types of instruments available for investment. Nevertheless, there are still over two dozen countries that are one-dimensional, typically with illiquid dollar-denominated government debt.

Best ideas portfolios actively seek growing economies that are expanding capital markets and tools. This capital market development not only improves liquidity but serves as an indicator of fundamental improvement in a country, of new relationships to evaluate for mispricing and of improved tools to gain tailored exposures.

Figure 3: Emerging market debt is a deep and varied asset class
