Review of approach to Emerging Market Debt ("EMD")

September 2019

Introduction

- Emerging Market Debt ("EMD") captures a growing universe of corporate and sovereign debt issued in both hard currency (e.g. USD) and local currencies. With such a diverse yet distinct opportunity set, we believe EMD can play an important role in a Scheme's investment portfolio at almost any stage of the strategic journey.
- We do not revisit the strategic investment case for allocating to EMD in this note. Rather we have provided a recap on how allocations to EMD have evolved over time and set out why we think clients should consider adopting a "buy & refresh" approach to this asset class.

How clients have previously allocated to EMD

When many schemes first introduced allocations to EMD, the focus was on Local Currency bonds. The thesis for this approach was that emerging economies were likely to experience faster economic growth than developed economies, and that this was likely to put upward pressure on their currencies. In addition, the local currency universe had grown substantially in size and the average quality and fundamentals of the issuers was better than in the hard currency universe.

We reviewed this approach in 2015, and at that time we highlighted that, whilst on average it was reasonable to argue that emerging economies should outgrow developed economies, several other equally important factors could be expected to influence the performance of any single currency. In particular, we highlighted the heterogeneity of the universe, with economic potential, requirements for reform, and other relevant circumstances varying significantly across the opportunity set. We have seen several recent examples that have illustrated this, for example, Turkey, Venezuela and Argentina.

For these reasons, we argued that a total return approach should be adopted, investing across both the hard currency and local currency markets, rather than setting managers a local currency benchmark.

The expectation was that active managers would continue to invest in local currency bonds and cash, but only when they believed the return potential (from carry and currency appreciation) justified the risk, having considered all relevant factors (including economic, technical and valuation factors). At the time, local currencies had sold off significantly (following the "Taper Tantrum") and our view was that managers would be best placed to navigate the decisions on which local currency bonds and cash to invest in as well as on the aggregate exposure to local currencies versus hard currency bonds.

Over the three-year period since the total return approach was adopted, mandates managed in this way have outperformed the local currency benchmarks that they replaced as shown in the table (we have used the performance of a 50/50 blend index as a proxy for total returns). In addition, the volatility of returns for total return has been notably lower than that of local currency benchmarks.

Performance to 31 July 2019	Benchmark returns		
	Local currency Index	Hard currency Index	50% LC/ 50% HC Blend Index
1 year	8.0%	11.0%	9.5%
3 years (p.a.)	4.4%	5.3%	4.8%
5 years (p.a.)	-0.1%	5.5%	2.9%

Source: Lazard. Performance shown in US dollars

To this extent the change was a success. However, in our review meetings with the managers over this period, it has become increasingly apparent to us that the rationale supporting many of the local currency decisions they have taken has been extremely tactical in nature. Given this experience, we have reflected further on our preferred approach to accessing the asset class.

What we dislike about local currency decision making

We engaged extensively with asset managers when we advised our clients to adopt a total return approach over dedicated local currency bond allocations. Given the level of interaction, we felt there was a very good chance that the asset managers understood what we were hoping to achieve, and that they would therefore manage client assets in the way we intended. In particular, we had anticipated that managers would form views on which local currency emerging market bonds could be expected to generate strong risk-adjusted returns over a medium term (i.e. 5 to 10 year) time horizon, taking into account the multiple factors that influence exchange rates.

However, in practice, **managers have traded local currency exposures very actively, often expressing short term views, and frequently reversing their positioning**.

Furthermore, rather than being highly selective in their positioning, they have often traded a basket of local currencies as a simple local EM currency vs dollar macro trade. Whilst we maintain the view that the underlying country fundamentals may bear out over strategic time horizons, over the shorter-term local currency performance is driven predominantly by global macro factors. This dynamic has impacted the way managers have traded these positions.

In summary, the local currency components of these mandates have often looked significantly more like an EM-focused global macro hedge fund than we would have wanted or expected. This is a legitimate source of expected return, but it is not a source of return in which we have high conviction.

What we are looking for

We have a number of preferred investment characteristics that we look for in seeking to generate excess returns, in particular:

- Taking investment risk where there is a fundamental economic rationale that the risk is rewarded (e.g. credit risk);
- Assets that generate predictable and reliable cashflows;
- Avoiding fundamental risk of impairment; and
- Investing rather than trading strategies.

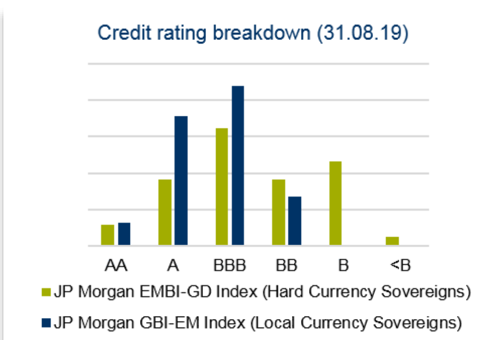
The preferences above lead us to favour fixed income and fixed-income like investments. Whilst EMD is a genuine fixed income asset class, the impact of the local currency component and the way in which this has been managed by managers has meant that EMD allocations have often failed to demonstrate the preferred characteristics highlighted above.

Considering a buy & refresh approach

Given our preference for investing over trading, we increasingly favour a hold to maturity style of asset management. Unless managers are explicitly encouraged to think in this way, they almost always default to buying securities that they believe will appreciate, either in absolute terms, or relative to a benchmark index, in the expectation that they will be able to sell the security and move on.

Whilst we are happy for managers to recycle capital in this way, we would prefer them to only make the investment in the first place if they are happy to hold on to it. This reduces the risk of selling assets due to short-term underperformance (which often happens in very actively managed portfolios). Instead, if the initial thesis was robust, and the security underperforms, the reasonable expectation should be that the forward-looking expected return has increased, and the case for continuing to hold the security has improved.

This style preference has led us to explore the possibility of adopting a buy-and-refresh approach to the management of emerging market debt mandates. This would result in portfolios dominated by hard currency exposures, although local currency exposures would be permitted as long as the manager felt that they were appropriate on a hold to maturity basis. In practice, this is likely to only include select stressed/distressed opportunities that the managers would be happy to "lock away". Mandates would continue to provide exposure to both sovereign and corporate issuers, and both investment grade and sub-investment grade parts of the market.



A move to a hard currency focussed approach is likely to involve a higher degree of credit risk in place of currency risk (the average credit quality of the hard currency universe is lower than that of local currency bonds) as shown in the chart. We are comfortable with this as **we have a higher degree of conviction in credit risk (versus currency risk) as a structural source of** return. We also have much greater confidence in a credit manager's ability to do the fundamental work than a currency manager's ability to exploit opportunities in currency markets.

That being said, we acknowledge that some managers have been successful in actively trading local currency exposures. For investors who wish to retain an allocation to alpha from this source of active management, the case for moving to a more "strategic" credit-focussed approach would be more marginal.

However, given the way that local currency allocations are implemented, in our view, an allocation to local currency should be viewed primarily as an allocation to manager skill rather than being viewed as a strategic allocation.

Summary

- The move from local currency, benchmark-relative, emerging market debt mandates to total return mandates has been successful from both a risk and a return perspective. The total return approach has also been welcomed by managers. However, it has become increasingly evident to us that the local currency exposures within these mandates are managed extremely actively, and that managers very rarely take the view that an individual local currency cash or bond exposure will generate strong risk-adjusted returns over a secular time horizon.
- For this reason, we have reflected further on our preferred approach to accessing the asset class. Given our preference for investing over trading, we would encourage managers to adopt a hold to maturity mind-set and for clients to consider a "buy & refresh" approach to EMD.

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