

With the popularity of emerging markets growing, and the realisation that developed sovereign debt is not totally risk free, attention is turning increasingly towards emerging market debt markets.

The combination of underlying economic growth and fiscal responsibility means that debt has fallen to levels of around 40% of GDP in most emerging markets. This stands in sharp contrast to the 100%+ ratios found in some parts of the developed world.

An investment in the more than \$2,800bn of emerging market debt in issue today is effectively an investment in the future tax revenues of the issuing nation. With the economic fundamentals of many emerging markets looking sounder than they are in some developed nations, this investment has solid foundations. However, it is more than just the economic outlook that should make emerging market debt an attractive opportunity for investors.

Portfolio benefits

The bonds of emerging market issuers tend to exhibit low correlation with other asset classes. This means that their inclusion in a portfolio can improve returns without significantly altering the risk profile or raising volatility. In other words, they are of great value when it comes to improving portfolio diversification.

They also tend to offer attractive yields relative to other asset classes, on a risk-adjusted basis. For example, although yields have fallen, partly as a reflection of improved credit quality, they still compare well to those of developed market government debt. Ten year UK gilts yield around 3.5%, whereas the average yield on emerging market debt is 6.3%. This could provide a valuable source of income for pension schemes challenged by the low rates in developed world economies.

Although yields have further potential to contract as emerging markets become more mature, by investing in longer dated debt, emerging market investors still have the opportunity to benefit from the simultaneous capital appreciation.

New markets

In the past, investors could only invest in these markets through US dollar-denominated

Making the case for emerging markets

Anne-Sophie Girault says trustees should look at emerging market debt opportunities



issues. The market grew up on hard currency bonds as investors shied away from currency risk. However, as the market has grown, governments have moved towards bonds issued in their local currency. They have realised that predominantly borrowing in a currency other than their own leaves an economy vulnerable to fluctuating foreign exchange markets. This local issuance has created two new opportunities for investors in opening up a new market and in giving them the ability to exploit currency movements to add value to a portfolio.

Today, the local currency bond market is the fastest growing part of the emerging market debt universe and is now larger than the market in hard currency debt. This has been made possible because the steady improvement in macroeconomic policies has been recognised by the ratings agencies, which have rewarded sovereign debt issuers with ratings upgrades.

The improving macroeconomic fundamentals are also attracting capital to emerging markets, with significant inflows into higher yielding currencies. Emerging market bonds denominated in local currency benefit from the currency appreciation that accompanies these inflows.

However, the combination of capital flows into the developing world, high commodity prices, economic growth above capacity and relatively loose monetary policy means that inflationary pressures are more pronounced than in the developed world. Estimates as at the end of 2010 suggest inflation running as low as 1.4% per annum in Chile but as high as 12% per annum in India. To reduce the risk of inflation eroding returns, the inflation-linked bond market in emerging markets has grown rapidly in recent years and may now be more

attractive than nominal bonds for investors seeking exposure to emerging markets that have experienced high and volatile business and inflation cycles.

Issuance in the inflation-linked market is dominated by Latin American countries, primarily Brazil, but other regions such as Eastern Europe, Africa and Asia now offer 'linkers' and we should see deeper markets reinforce the attractions of this new asset class.

Building an exposure

We remain confident that returns from emerging market debt will outpace those of developed markets over the next few years but how can pension schemes access these markets? They could decide to buy directly into sovereign bonds. However, this can be a costly process because of the complex due diligence requirements and the trading costs associated with these markets. A more cost effective solution might be to build exposure through funds. Most asset management companies with a sound fixed income capability will offer some form of emerging market debt fund. A growing number can offer more tailored solutions which specialise in the local, hard currency or inflation-linked markets. These funds provide a simple route into a diversified portfolio of bonds with some of the most attractive risk-reward characteristics to be found in fixed income markets today. ■

Anne-Sophie Girault, head of fixed income client portfolio management, Aviva Investors.



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