Ashmore

The Emerging View

Blended Debt: Enhance Returns and Reduce Risk

Jan Dehn October 2012 Issue No. 97

Head Office:

London:
T: +44 20 3077 6000

Other Locations:

Beijing:
T: +86 10 8800 9235

Bogota:
T: +57 1 347 0649

Istanbul:
T: +90 212 349 40 00

Melbourne:
T: +61 0 3 9653 9524

Moscow:
T: +74 9566 04258

Mumbai:
T: +91 22 6608 0000

New York:
T: +1 212 661 0061

Sao Paulo
T: +55 11 3556 8900

Singapore:
T: +65 6823 1319

Tokyo:
T: +81 0 3 6860 3777

Introduction

Blended Emerging Markets debt is a strategy which combines external sovereign debt, corporate debt, local currency debt, and FX. The manager not only makes the usual credit, currency, and exposure calls, but also tactically allocates between themes to further enhance returns. This requires specialist Emerging Market investment skills.

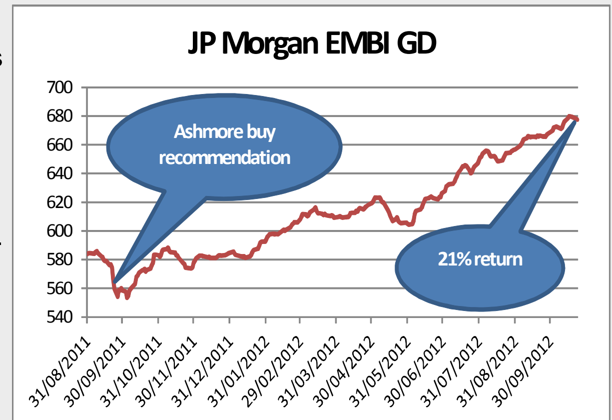
Blended debt is particularly suited to the current global macroeconomic environment. Emerging Market asset prices and currencies are frequently buffeted by non-Emerging Market events, such as collapses in confidence, Fed and ECB policy interventions, weak data, and genuine repayment risks. These events almost always emanate from the HIDCs ('Heavily Indebted Developed Countries').

Set against the solid fundamentals in Emerging Markets, these bouts of 'HIDC panic' usually present opportunities to add Emerging Market exposure at attractive prices. But these episodes also create distortions in the relative value between Emerging Market fixed income themes. These distortions can be exploited to further enhance returns through tactical asset allocation.

In this paper, we explain why a blended debt strategy might suit some investors. We also revisit the case for individual fixed income themes and compare their outlook with equivalent themes in the HIDCs.

Why Blended Debt?

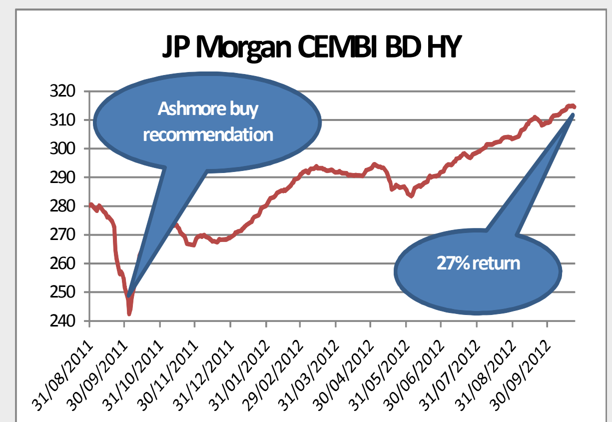
It is well-known that HIDC panics can temporarily weaken Emerging Market asset prices, mainly because cross-over investors and banks shift into dollars and US treasuries and momentum-type investors jump onto the band wagon. It is less well-known, but entirely demonstrable that HIDC panics are nearly always excellent opportunities to add Emerging Markets exposure. For example, those investors who followed our recommendation— issued at the height of the panic over Greece on the 29 September 2011—to buy Emerging Market sovereign and corporate debt will have made 21% and 27%, respectively. The reason why HIDC panics create buying opportunities is simple. Credit fundamentals have not worsened, but prices have fallen, so investors are de facto given a discount.



Source: JP Morgan, Bloomberg, Ashmore

To take advantage of such discounts, it is necessary to invest in accordance with a process, which explicitly recognizes that price volatility can be—and often is—a very poor proxy for risk. The investment process should pay special attention to credit fundamentals, because the only way to determine if falling prices reflect genuine credit deterioration or whether they are merely a case of mispricing (i.e. a buying opportunity) is to look closely at the credit itself. Contrary to Modern Portfolio Theory, asset prices alone do not always capture actual risks—or the lack thereof, let alone distinguish between sound and deteriorating credits.

The mispricing of Emerging Market asset prices during HIDC panics often affects different asset classes to different degrees. In the past couple of years it has become customary for the market to vent its HIDC fears in the currency markets more so than in credit space. When HIDC panics impact the relative opportunity set within Emerging Markets it is possible to add alpha not just by buying dips, but also by tactically rejigging the portfolio between asset classes. Asset rotation can also minimize inefficient use of capital, such as excessive cash balances.



Source: JP Morgan, Bloomberg, Ashmore

Ashmore Investment Management Limited
61 Aldwych
London
WC2B 4AE
T: +44 20 3077 6000

Bloomberg Page:
Ashmore <GO>

Fund Prices:
Bloomberg, FT.com, Reuters, S&P, Lipper

Website:
www.ashmoregroup.com

IMPORTANT INFORMATION

No part of this article may be reproduced in any form, or referred to in any other publication, without the written permission of Ashmore Investment Management Limited © 2012

This document is issued by Ashmore Investment Management Limited (Ashmore), which is authorised & regulated by the Financial Services Authority. The information and any opinions contained in this document have been compiled in good faith, but no representation or warranty, express or implied, is made as to accuracy, completeness or correctness. Save to the extent (if any) that exclusion of liability is prohibited by any applicable law or regulation, Ashmore, its officers, employees, representatives and agents expressly advise that they shall not be liable in any respect whatsoever for any loss or damage, whether direct, indirect, consequential or otherwise however arising (whether in negligence or otherwise) out of or in connection with the contents of or any omissions from this document. This document does not constitute an offer to sell, purchase, subscribe for or otherwise invest in Units of any Fund referred to above and is not intended to provide advice on the merits of investing in any particular fund. The value of the Units may fall as well as rise and investors may not get back the amount originally invested. With the exception of the SICAV fund, Ashmore's public funds are only available to persons defined as Professional Clients and Eligible Counterparties under the rules of the Financial Services Authority of the United Kingdom. Prospective investors should obtain and review the Scheme Particulars or other offering documents relating to the units or shares of any Fund, including the description of risk factors/investment considerations contained in the Scheme Particulars or other offering documents, prior to making any decision to invest in such Units or Shares. The funds are offshore and not regulated in the United Kingdom. Past performance is not a reliable indicator of future results.

Jan Dehn

October 2012 Issue No. 97

The table shows Emerging Market fixed income returns each year in the past 10 years, by theme. Each colour represents a different theme and the themes are ranked within each column by their return in that given year. For example, corporate debt was the best performing asset class in 2009 with 34.9% return, external sovereign debt was runner up with 29.8% return, and local currency bonds, and FX brought up the rear with 22.2% and 11.7% return, respectively. But in the preceding year the order of performance was literally exactly the opposite to 2009, when currencies outperformed both local and external credit. And in 2010 the order was once again different with local currency bonds performing best among the four themes.

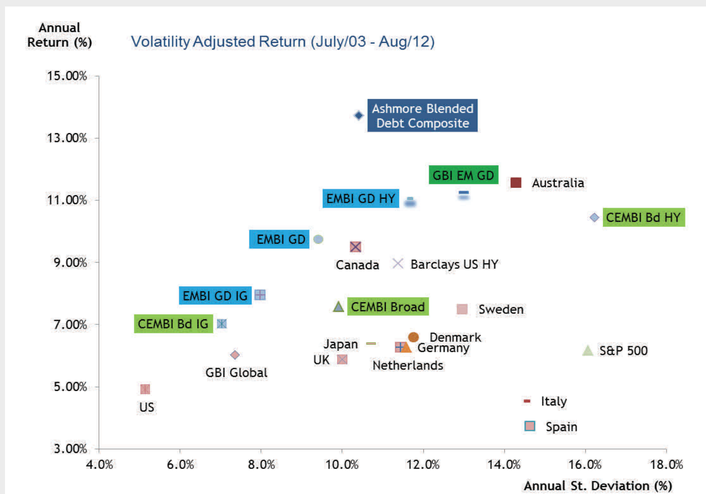
2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
EMBI GD 13.65%	EMBI GD 22.2%	GBI-EM GD 23.0%	EMBI GD 10.2%	GBI-EM GD 15.2%	GBI-EM GD 18.1%	ELMI+ -3.8%	CEMBI BD 34.9%	GBI-EM GD 15.7%	EMBI GD 7.35%
ELMI+ 11.43%	GBI-EM GD 16.9%	ELMI+ 14.8%	GBI-EM GD 6.3%	ELMI+ 12.3%	ELMI+ 16.0%	GBI-EM GD -5.2%	EMBI GD 29.8%	CEMBI BD 13.1%	CEMBI BD 2.31%
CEMBI BD 10.90%	CEMBI BD 16.2%	EMBI GD 11.6%	CEMBI BD 6.1%	EMBI GD 9.9%	EMBI GD 6.2%	EMBI GD -12.0%	GBI-EM GD 22.0%	EMBI GD 12.2%	GBI-EM GD -1.75%
	ELMI+ 15.8%	CEMBI BD 10.3%	ELMI+ 3.2%	CEMBI BD 6.5%	CEMBI BD 3.9%	CEMBI BD -15.9%	ELMI+ 11.7%	ELMI+ 5.7%	ELMI+ -5.19%

Source: JP Morgan, Bloomberg, Ashmore

Blended debt strategies reference blended indices of hard and local currency bonds, such as the JP Morgan EMBI GD and GBI indices. Benchmark awareness is important, but sizing positions with reference to index weights can be dangerous and inefficient due to extensive mispricing of Emerging Market credits and themes. Active management can therefore add considerable value. But active management of themes, currencies and credits presents both opportunity and challenge.

The challenge is that managers must be nimble, able to recognize relative value within a highly complex and diverse Emerging Markets fixed income space with higher barriers to entry. This requires specialist skills, particularly local knowledge about domestic political and economic conditions, an appreciation of liquidity in domestic markets, and insights into the incentives facing the local investor base.

The opportunity is that tactical asset allocation between themes can significantly augment overall returns.



Source: JP Morgan, Bloomberg, Ashmore

One simple way to illustrate this is to plot returns against volatility for various asset classes. As the chart on the right shows, Ashmore's blended debt composite has better volatility adjusted returns than any other asset class over the past 10 years. It also has higher absolute returns than any other theme, both within and outside of Emerging Markets. Blended debt outperforms other Emerging Market fixed income themes on a stand-alone basis and beats so-called 'core' markets like German, Danish, or Dutch government bonds and HIDC stock markets, such as the S&P500.

Why Emerging Markets?

We believe that Emerging Markets fixed income is less risky and offers better value than HIDC bonds. The relative safety and value of Emerging Markets rests on three core pillars: First, Emerging Market economies are growing faster. Emerging Markets should grow about 5% in real terms this year, accelerating to at least 6% next year, which is 3 to 5 times faster than the HIDCs. With domestic demand now the more important driver of growth we believe Emerging Market growth is more robust.

Ashmore Investment Management Limited
61 Aldwych London
WC2B 4AE
T: +44 20 3077 6000

Bloomberg Page:
Ashmore <GO>

Fund Prices:
Bloomberg, FT.com, Reuters, S&P, Lipper

Website:
www.AshmoreGroup.com

IMPORTANT INFORMATION

No part of this article may be reproduced in any form, or referred to in any other publication, without the written permission of Ashmore Investment Management Limited © 2012

This document is issued by Ashmore Investment Management Limited (Ashmore), which is authorised & regulated by the Financial Services Authority. The information and any opinions contained in this document have been compiled in good faith, but no representation or warranty, express or implied, is made as to accuracy, completeness or correctness. Save to the extent (if any) that exclusion of liability is prohibited by any applicable law or regulation, Ashmore, its officers, employees, representatives and agents expressly advise that they shall not be liable in any respect whatsoever for any loss or damage, whether direct, indirect, consequential or otherwise however arising (whether in negligence or otherwise) out of or in connection with the contents of or any omissions from this document. This document does not constitute an offer to sell, purchase, subscribe for or otherwise invest in Units of any Fund referred to above and is not intended to provide advice on the merits of investing in any particular fund. The value of the Units may fall as well as rise and investors may not get back the amount originally invested. With the exception of the SICAV fund, Ashmore's public funds are only available to persons defined as Professional Clients and Eligible Counterparties under the rules of the Financial Services Authority of the United Kingdom. Prospective investors should obtain and review the Scheme Particulars or other offering documents relating to the units or shares of any Fund, including the description of risk factors/investment considerations contained in the Scheme Particulars or other offering documents, prior to making any decision to invest in such Units or Shares. The funds are offshore and not regulated in the United Kingdom. Past performance is not a reliable indicator of future results.

Second, Emerging Markets are far less indebted. One particularly relevant measure of indebtedness is total public and private sector external debt as a share of GDP. In Emerging Markets, this is running at just 25% versus 250% in HIDCs. About three quarters of the more than 60 readily investable countries in Emerging Markets are now investment grade. We have not had an Emerging Market contagion since the 1990s.

Thirdly, Emerging Market economies have buffers against shocks. Governments have room to loosen fiscal policy and central banks have room to ease monetary policy. Emerging Markets control 80% of the world's FX reserves and lend money to the IMF, not the other way around.

Where is the value?

In addition to stronger fundamentals, we also believe that Emerging Market fixed income also offers better value. By theme:

(a) Sovereign Debt: At more than 250bps over US treasuries, Emerging Market sovereign spreads are nearly 100bps wide of their historical lows (165bps over treasuries). By contrast, in HIDCs sovereign bond yields have never been lower, debts never been larger, and monetary policy never been easier. Investors buying HIDC bonds are doing so despite negative real value, mainly because their prices are rising. But buying because prices are going up despite negative real value is the epitome of bubble behaviour, and ought to be a major warning sign for any strategic investor. Meanwhile, periphery HIDC economies face rising debt service costs amidst severe economic downturns and depend critically on on-going intervention from policy makers. Is speculating on timely interventions by European policy makers good long-term investing? With periphery yields in the 5-6% area we do not think so.

(b) Corporate debt: Emerging Market Corporate High Yield debt today pays about 600bps more than a US treasury bond of the same duration. This spread traded 250bps over treasuries before Lehman. Emerging Market sub-investment grade corporates are very different from typical US or European high yield companies. They are typically cash rich companies with large market share operating in growth economies. They have little debt, having mainly invested from retained earnings in the face of still very significant capital constraints. This also means that supply is highly elastic, making a demand driven bubble very unlikely. Default rates are lower and they pay more. Diversification benefits are significant.

(c) Local rates:

Emerging Markets local currency debt has some extremely attractive features. Firstly, local currency bonds pay nearly 6% for the same duration, which, in the US treasury market, pays just 75bps. In other words, Emerging Market local bonds pay about seven and half times more running yield. A portfolio of Emerging Market local bonds is also less volatile than US treasuries, in our opinion (see "The Great Flight from Liabilities", The Emerging View, May 2012). Local currency bond yields have traded in a stable 2% range for the past decade.

Second, Emerging Market local currency bonds are largely uncorrelated with US treasury yields. The reason is that local bonds are owned mainly by local institutional investors, who are in the main not allowed to invest outside their country. The lack of correlation with treasury yields is an extremely attractive feature for anyone who worries about how their fixed income portfolio will be impacted when US treasury yields normalize.

Finally, the local currency bond market is a rapidly expanding universe, which we expect to reach $20trn by the end of this decade (the tradable UST market today is about $10trn). Price elasticity of supply is also high in this space given relative infancy of most local currency bond markets in Emerging Markets.

(d) Local FX:

In today's febrile low-conviction markets, Emerging Market currencies often carry the brunt of shifts in sentiment. Currencies are therefore likely to be the most actively traded theme within a blended debt portfolio. Trend appreciation in Emerging Market currencies has been temporarily slowed down by on-going deleveraging in Europe and the US (see "Phoney Currency Wars", The Emerging View, August 2012). But Emerging Market FX forwards have still returned 2.4% per year since 2010. Emerging Market currencies are therefore a de facto insurance policy against dollar depreciation with a negative premium, that is, you are paid to insure.

What are you insuring against? You insure against open-ended QE and the eventual inflation

Ashmore Investment Management Limited
61 Aldwych London
WC2B 4AE
T: +44 20 3077 6000

Bloomberg Page:
Ashmore <GO>

Fund Prices:
Bloomberg, FT.com, Reuters, S&P, Lipper

Website:
www.AshmoreGroup.com

IMPORTANT INFORMATION

No part of this article may be reproduced in any form, or referred to in any other publication, without the written permission of Ashmore Investment Management Limited © 2012

This document is issued by Ashmore Investment Management Limited (Ashmore), which is authorised & regulated by the Financial Services Authority. The information and any opinions contained in this document have been compiled in good faith, but no representation or warranty, express or implied, is made as to accuracy, completeness or correctness. Save to the extent (if any) that exclusion of liability is prohibited by any applicable law or regulation, Ashmore, its officers, employees, representatives and agents expressly advise that they shall not be liable in any respect whatsoever for any loss or damage, whether direct, indirect, consequential or otherwise however arising (whether in negligence or otherwise) out of or in connection with the contents of or any omissions from this document. This document does not constitute an offer to sell, purchase, subscribe for or otherwise invest in Units of any Fund referred to above and is not intended to provide advice on the merits of investing in any particular fund. The value of the Units may fall as well as rise and investors may not get back the amount originally invested. With the exception of the SICAV fund, Ashmore's public funds are only available to persons defined as Professional Clients and Eligible Counterparties under the rules of the Financial Services Authority of the United Kingdom. Prospective investors should obtain and review the Scheme Particulars or other offering documents relating to the units or shares of any Fund, including the description of risk factors/investment considerations contained in the Scheme Particulars or other offering documents, prior to making any decision to invest in such Units or Shares. The funds are offshore and not regulated in the United Kingdom. Past performance is not a reliable indicator of future results.

and currency re-alignment, which we believe will become manifest once consumer spending shows signs of recovering in the US, or sooner if central banks or policy makers get impatient. Huge positions in so-called 'safe havens' should be unwound when this happens and Emerging Market currencies should experience sharp appreciation pressure, in our view.

How far can the dollar move? One way to think about this is to consider the stock of US public debt. The US debt to GDP ratio has risen 40% over the past four years and already lingers just above 100%. We think public debt could easily hit 110% of GDP by 2016, given the fiscal outlook. Bringing this number down to a 60% level more consistent with trend growth by fiscal adjust alone is nearly impossible, in our view. That is why we believe we are facing a mega currency adjustment of circa 25%. We believe that Emerging Markets currency exposure is the only way to turn this otherwise negative event into a major upside for your portfolio.

Ashmore Investment Management Limited
61 Aldwych London
WC2B 4AE
T: +44 20 3077 6000

Bloomberg Page:
Ashmore <GO>

Fund Prices:
Bloomberg, FT.com, Reuters, S&P, Lipper

Website:
www.AshmoreGroup.com

IMPORTANT INFORMATION

No part of this article may be reproduced in any form, or referred to in any other publication, without the written permission of Ashmore Investment Management Limited © 2012

This document is issued by Ashmore Investment Management Limited (Ashmore), which is authorised & regulated by the Financial Services Authority. The information and any opinions contained in this document have been compiled in good faith, but no representation or warranty, express or implied, is made as to accuracy, completeness or correctness. Save to the extent (if any) that exclusion of liability is prohibited by any applicable law or regulation, Ashmore, its officers, employees, representatives and agents expressly advise that they shall not be liable in any respect whatsoever for any loss or damage, whether direct, indirect, consequential or otherwise however arising (whether in negligence or otherwise) out of or in connection with the contents of or any omissions from this document. This document does not constitute an offer to sell, purchase, subscribe for or otherwise invest in Units of any Fund referred to above and is not intended to provide advice on the merits of investing in any particular fund. The value of the Units may fall as well as rise and investors may not get back the amount originally invested. With the exception of the SICAV fund, Ashmore's public funds are only available to persons defined as Professional Clients and Eligible Counterparties under the rules of the Financial Services Authority of the United Kingdom. Prospective investors should obtain and review the Scheme Particulars or other offering documents relating to the units or shares of any Fund, including the description of risk factors/investment considerations contained in the Scheme Particulars or other offering documents, prior to making any decision to invest in such Units or Shares. The funds are offshore and not regulated in the United Kingdom. Past performance is not a reliable indicator of future results.