

Beware rules of thumb

By Jan Dehn

Investors of all types tend to act in accordance with rules of thumb. There are many, but one of the most deeply entrenched is that outbreaks of global uncertainty are bad for Emerging Markets (EM). As a result, investors almost invariably reduce their exposures to EM during risk-off events, usually increasing their allocations to US Dollars and US treasuries. But is this response rational? More importantly, is it profitable? We examined the returns across all EM fixed income asset classes in the aftermath of VIX spikes and found the opposite has been true. Significant excess returns can be gained by reversing this particular rule of thumb and going against the herd.

The results of our research are summarised in the table below but the key findings are:

1. Investors can lock in significant excess returns in all EM fixed income asset classes reviewed by allocating to EM during VIX spikes compared to randomly timing allocations to the asset class.*
2. The excess return from buying during VIX spikes ranges from 1.1% and 4.1% over a 12 month horizon.
3. The highest excess return accrues to EM investment grade external sovereign debt (4.1%) followed by EM local currency sovereign bonds (3.3%). The excess return for EM investment grade corporate credit is 2.4%, that for EM non-investment grade corporate and sovereign credit is 1.9% and the excess return in EM FX is 1.1%.
4. Excess returns accrue most rapidly to EM investment grade sovereign debt (both Dollar and local currency). We suspect sovereign debt recovers more quickly than credit due to EM's generally strong sovereign fundamentals, while credit behaves more like equities, that is, it falls far and faster, but recovers more slowly. In fact, our results show that buying corporate high yield too soon after VIX shocks can be loss-making.

Table 1. Annualised returns after VIX spikes versus returns on randomly timed purchases (since January 2003).

	External debt (IG)	External debt (Non IG)	Corporate dollar debt (IG)	Corporate dollar debt (Non IG)	Local current government debt	EM FX forwards
12 months excess return	4.1	1.9	2.4	1.9	3.3	1.1
Return 12 months after VIX spike	11.2	13.0	9.1	12.5	12.8	7.1
Return on random purchases	7.1	11.2	6.8	10.6	9.4	5.9

Returns over other periods after VIX spikes

Return 3 months after VIX spike	14.3	10.2	6.0	-1.8	10.7	3.1
Return 6 months after VIX spike	9.6	9.2	5.9	0.1	8.6	3.4
Return 24 months after VIX spike	8.5	10.3	7.6	9.8	8.7	4.5

Source: JP Morgan, Ashmore.

*Please note this does not include EM local currency corporate debt as sufficiently long data for this asset class is not currently available.

Discussion

Why are excess returns so large in EM following spikes in VIX?

There is overwhelming evidence that many EM investors act in accordance with simple rules of thumb. When global risk aversion rises, they fall for the shrill predictions of doom. They play on widely held but outdated views that EM is a homogenous asset class whose fundamental health depends critically on conditions in developed economies, despite abundant evidence to the contrary.

Excess returns following global risk-off episodes are large because rules of thumb create enormous inefficiencies, both across and within the EM fixed income universe. Time and time again, EM fundamentals have resisted derailment by the volatility caused by portfolio flows. After each VIX spike, when the dust has settled, it turns out that asset prices have moved far more than fundamentals.

After a hiatus of three years, VIX spiked more than 10 points in the middle of October this year due to fears of a policy mistake by the Fed. Based on our results, this suggests that there is

value to be had in EM. Yet, we do not advocate that investors simply substitute one rule of thumb for another. Investors should not buy EM blindly just because of VIX spikes. The correct conclusion to draw from our analysis is that investors need to pay far more attention to EM fundamentals and less attention to the media, investment banks and others with strong incentives to generate hysteria and flow. They should look to bouts of risk aversion as good potential entry points for additional allocations to EM, while never neglecting due diligence.

The broader implication arising from our analysis is that EM asset price volatility is a particularly bad measure of riskiness in EM; otherwise the excess returns following VIX spikes would simply not be there. EM's excess asset price volatility is principally caused by investor behaviour, not by rocky fundamentals. Institutions that still use asset price volatility as their main gauge of risk should review this practice.

Conclusion

Our results show that investors can harvest significant excess returns by going against the herd. Sadly, this is not going to change behaviour overnight. Going against the herd is tough, because it means running counter to deeply entrenched institutional incentives, overcoming ignorance, fighting prejudice and other intractable problems. But now at least we can quantify how much it costs to run with the herd.

Methodology

Our hypothesis is that EM fixed income is oversold during VIX shocks. If this is true, returns in the aftermath of VIX shocks should be superior to average returns across all periods. In other words, investors who allocate during VIX shocks should be able to lock in higher returns than if they allocated at entirely random times.

To test this hypothesis, we calculated and compared returns for allocations timed to coincide with VIX shocks with the returns arising from randomly timed allocations to EM.

Using industry-standard EM fixed income benchmark indices, we calculated annualised returns for each EM fixed income asset class over three, six, twelve, and twenty-four month periods following 10+ points spikes in VIX. Returns based on randomly timed allocations were calculated simply as the average annualised return for the whole history of the series. See appendix for more details.

We identified VIX shocks using the methodology of Bock and Filho, who define global risk-off episodes as spikes of 10 points or more in the VIX index (CBOE's index of implied volatility of the index options of the S&P 500 stock market index).¹ The VIX index annualises the expected movement in the S&P 500 index over the next 30 days. As such, it is a forward-looking indicator of risk appetite, which is largely exogenous to the vast majority of individual EM countries. Table 2 identifies episodes of 10+ point moves in the VIX since the early 1990s.²

Table 2. 10+ point moves in the VIX

4 August 1990	Fears for the US economy
14 January 1991	First Gulf War
4 April 1994	Fed hikes
29 October 1997	Asian crisis
4 August 1998	Russian crisis and LTCM
12 October 2000	Fear of slowing US economy (dotcom bubble collapses)
17 September 2001	9/11
10 July 2002	Fear of slowing US economy/tighter liquidity
13 June 2006	Hike triggers recession fears
10 August 2007	BNP Paribas gates funds over sub-prime losses
17 September 2008	Lehman
6 May 2010	Greek default fears
16 March 2011	Japan earthquake
4 August 2011	US debt ceiling and Eurozone crisis
13 October 2014	Fed rate hike fears

Source: Bock and Filho, Ashmore.

¹ Reinout De Bock and Irineu de Carvalho Filho (2013) "The Behaviour of Currencies during Risk-off Episodes", IMF Working Paper, No. 8 (January 2013).

² Two of the VIX spikes in the table relate to specific EM events (the Asian and Russian crises in 1997 and 1998). These episodes involved considerable fundamental stress in several EM countries. Should those events be included in this analysis? We opted to include the two shocks on the grounds that: (a) not all EM countries experienced fundamental problems at the time; and (b) to the extent that those shocks weakened EM fundamentally, the subsequent returns should be weaker, all else even. In other words, our analysis errs on the side of caution.

Appendix

The results reported in the main body of the paper are based on the longest available time series for all the EM fixed income indices (i.e. starting January 2003). We also calculated excess returns for longer periods for those EM fixed income classes where longer data series are available – see the Table 3 below. The results were even stronger than those reported in Table 1.

Table 3. **Excess returns using longest possible time series for each EM fixed income asset class**

	External debt (IG)	External debt (Non IG)	Corporate dollar debt (IG)	Corporate dollar debt (Non IG)	Local current government debt	EM FX forwards
12 months excess return	3.2	1.9	2.5	7.5	3.3	3.6
Return 12 months after VIX spike	11.3	13.2	9.8	17.7	12.8	10.1
Return on random purchases	8.1	11.3	7.3	10.1	9.5	6.5

Returns over other periods after VIX spikes

Return 3 months after VIX spike	18.5	32.0	7.3	3.9	10.7	11.3
Return 6 months after VIX spike	12.1	20.6	7.5	7.7	8.6	8.7
Return 24 months after VIX spike	10.4	14.8	8.1	12.8	8.7	8.2

Source: JP Morgan, Ashmore.

EM external debt and FX forward indices (EMBI GD and ELMF+, respectively) start on 31 December 1993. Corporate bond indices (family of CEMBI indices) begin on 31 December 2001. The local currency bond index (GBI EM GD) begins in January 2003. We note that due to strong spread compression and currency appreciation during the earlier periods the excess returns specifically attributable VIX spikes may have been amplified during this period, particularly for calculations of excess returns over six months or longer following the VIX shocks.

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