

Superior returns and lower risk in EM IG Corporate bonds

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Using the longest available benchmark indices, we found that EM IG corporates offer potentially superior returns and lower risk than US IG corporates across time periods, maturity and ratings buckets. This implies that investors should consider reducing exposure to US IG corporate bonds in favour of their EM counterparts.

The existence of superior alternatives to developed market IG corporate bonds is particularly important at a time when an increasing amount of the sovereign and corporate bond universe in developed economies pays negative yields.

Introduction

Following years of QE, investors are rightly growing increasingly concerned about the lack of yield in conventional developed fixed income markets, where many bonds now pay negative yield, especially within the investment grade (IG) segment. Fortunately, there exists an attractive IG investment alternative within Emerging Markets (EM).

In this paper, our results show that EM IG corporates have offered superior returns and lower risks than US IG corporates across different time periods, maturity buckets and credit ratings. This calls into question the validity of allocating to any part of the US IG corporates universe as long as there is always a more profitable, less risky alternative available in EM.

We show that it is rational to allocate to EM IG corporate bonds in the context of a portfolio that has mainly US IG corporate debt today. In fact, the optimal allocation today would be 97% to EM IG corporates, given the volatility, yield and correlation characteristics of both asset classes.

Methodology

We calculate efficiency frontiers – annualised return versus annualised volatility – for US dollar-denominated IG corporate bonds in EM and the US for a 13 year sample period as well as sub-periods including 3-years, 5-years and 10-years. We also calculate efficiency frontiers for index duration buckets ranging from 1-3 year through to 10+ years. Finally, we calculate efficiency frontiers for the three rating buckets within the IG spectrum, BBB through to AA (ignoring AAA due to small sample size).¹

Main findings

EM IG corporate debt is systematically under-priced relative to US IG corporate debt. Specifically, EM IG corporates have delivered both higher returns and lower volatility – and hence outperformance versus US IG corporates – over the full sample period as well as over 3, 5 and 10 years' time horizons.

This is demonstrated in figure 1 (overleaf), which shows the outperformance of EM IG corporates across different levels of credit and maturity buckets. It is clear from the chart that all subsets of credit rating and duration within the EM IG corporate universe have exhibited superior performance over US IG corporates with similar credit or maturity profile.

Specifically, EM IG corporates have on average paid 77bps of additional return per year with only two thirds of the volatility of US IG corporates.

We find that the ratios of return to volatility of EM IG corporates have been close to 2 in most periods, whereas they have only been just above 1 for US IG corporates. Translated into risk-adjusted returns, this means that EM IG corporates would have

returned 3.9% more than US IG corporates per annum for the same level of volatility, i.e. a total return 75% higher, at 9.18% per annum vs. 5.25% for US IG corporates.

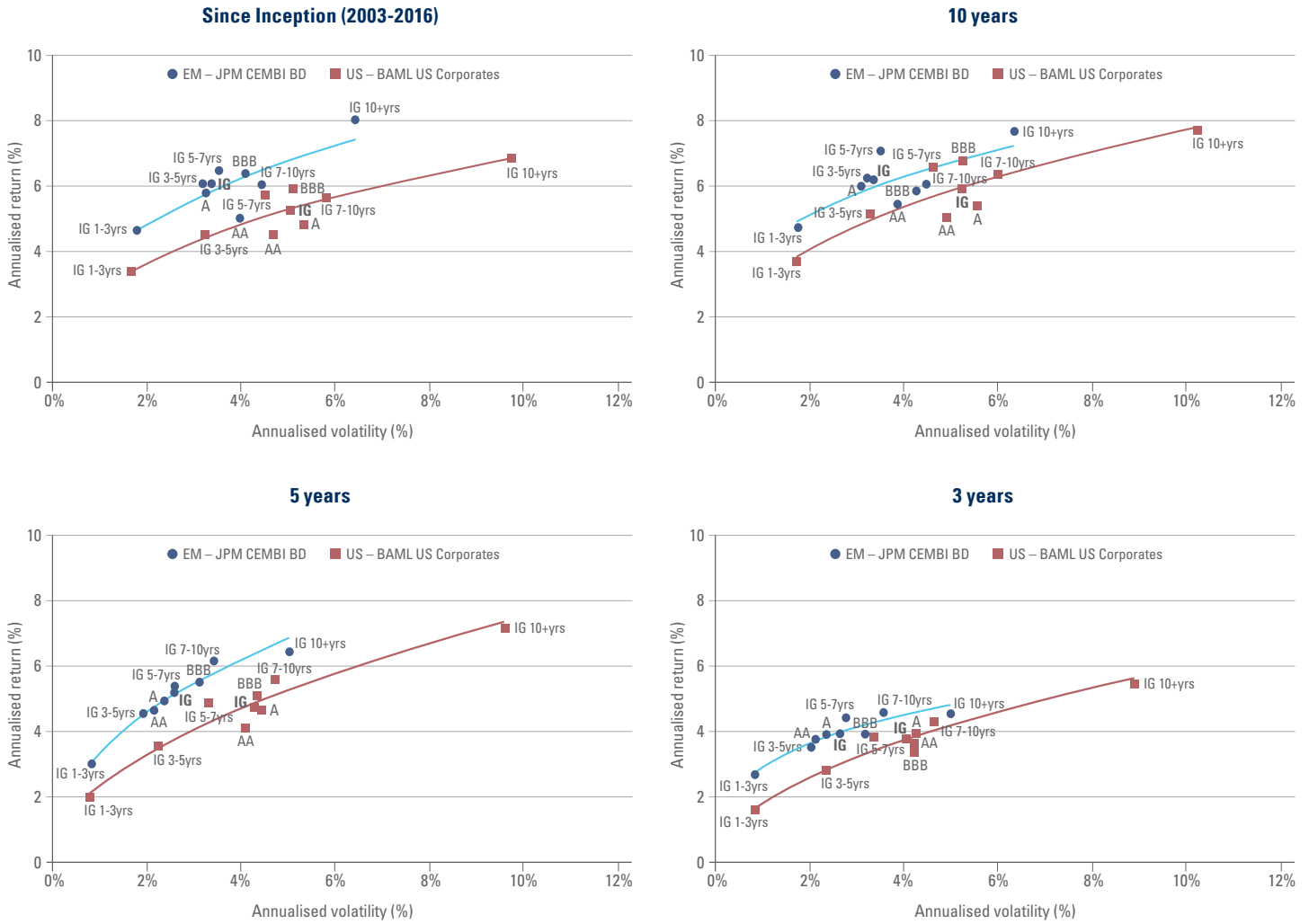
Alternatively, on a return-adjusted basis the annualised volatility of EM IG corporates would have been 2.15% lower than US IG corporates per annum, that is, an annualised volatility 43% lower, at 2.87% vs. 5.03% for US IG corporates.

In fact, when looking across all duration and credit rating buckets there is not a single time horizon when an EM IG corporates rating and duration bucket has had both a lower return and a higher volatility, whereas US IG corporates have had both lower returns and higher volatility than EM IG corporates in almost 80% of the situations.

We also find that EM IG corporates are wrongly rated. BBB-rated US corporates only yield the equivalent of A-rated EM corporates, while A-rated US corporates only yield the equivalent of AA-rated EM corporates. In other words, investors can switch from US IG corporates to EM IG corporates and “get a rating for free”.

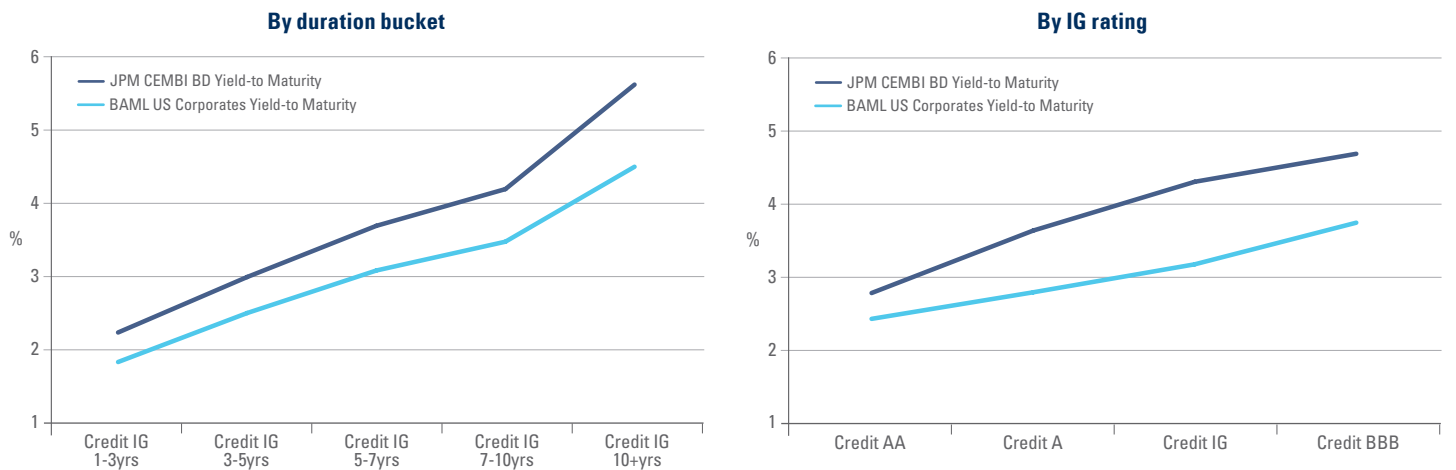
¹ The analysis is based on Bank of America Merrill Lynch's US IG corporate bond index and JP Morgan's CEMBI BD IG index. The data set span the period from 31 December 2003 – the inception of the EM sub-indices – through 31 May 2016.

Fig 1: Return versus volatility: EM vs US IG corporate bonds



The current yield pick-up available in EM is illustrated in figure 2. EM IG corporates today pay an even higher than average yield premium of 1.22% compared to similar US IG corporates.² The higher than usual yields-to-maturity premium suggests that EM's outperformance will continue in the foreseeable future. Larger than average yields-to-maturity premia are evident in all subsets of the EM IG corporate universe, which suggests that the basis for outperformance versus US IG corporates is broad-based.

Fig 2: Yield to maturity: EM vs US IG corporate bonds



Source: BAML, JP Morgan, Ashmore.

Source: BAML, JP Morgan, Ashmore.

² As of 28 June 2016.

Finally, correlation between names within the EM IG corporate asset class is lower than within the US IG corporate universe. For example, the correlation between AA and BBB credits in EM is only 50%, while it is 93% in the US IG corporate universe. The same is true for different duration buckets within the two asset classes (figure 3).

Fig 3: **Intra-asset class correlations: EM vs US IG corporate bonds**

EM: By duration

	IG 1-3yrs	IG 3-5yrs	IG 5-7yrs	IG 7-10yrs	IG 10yrs+
IG 1-3yrs	100%	70%	66%	68%	60%
IG 3-5yrs	70%	100%	80%	79%	68%
IG 5-7yrs	66%	80%	100%	84%	77%
IG 7-10yrs	68%	79%	84%	100%	84%
IG 10yrs +	60%	68%	77%	84%	100%

Source: BAML, JP Morgan, Ashmore.

US: By duration

	IG 1-3yrs	IG 3-5yrs	IG 5-7yrs	IG 7-10yrs	IG 10yrs+
IG 1-3yrs	100%	89%	84%	77%	57%
IG 3-5yrs	89%	100%	98%	93%	77%
IG 5-7yrs	84%	98%	100%	96%	83%
IG 7-10yrs	77%	93%	96%	100%	92%
IG 10yrs +	57%	77%	83%	92%	100%

Source: BAML, JP Morgan, Ashmore.

EM: By rating

	AA	A	BBB
AA	100%	69%	50%
A	69%	100%	70%
BBB	50%	70%	100%

Source: BAML, JP Morgan, Ashmore.

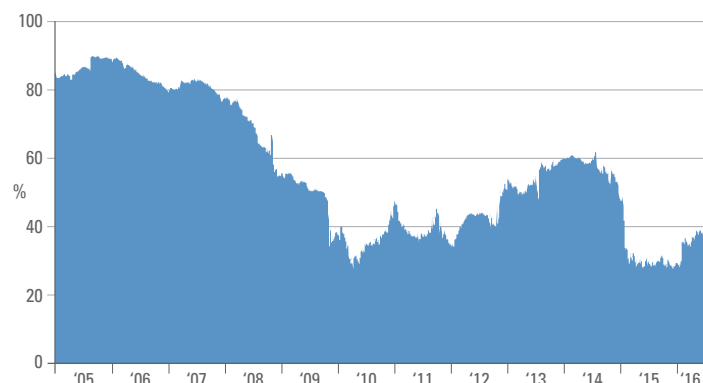
US: By rating

	AA	A	BBB
AA	100%	97%	93%
A	97%	100%	95%
BBB	93%	95%	100%

Source: BAML, JP Morgan, Ashmore.

At the same time, the correlation between EM and US IG corporate returns has steadily declined over time from nearly 90% in 2005 to less than 40% today (figure 4).

Fig 4: **1-year correlations between US and EM IG corporate bonds**



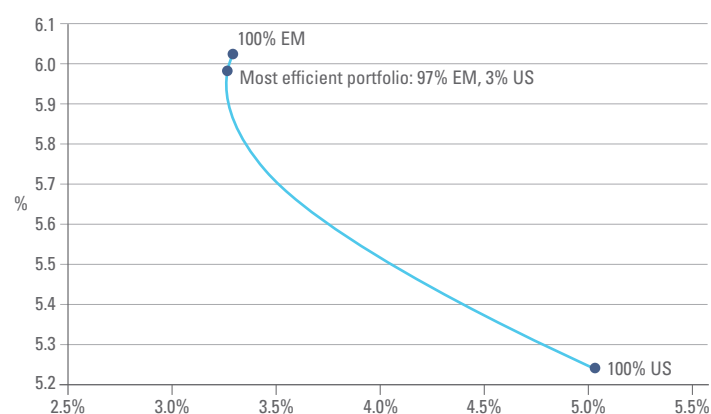
Source: BAML, JP Morgan, Ashmore.

Investors can add performance to a portfolio of US IG corporate bonds by adding EM IG corporates, while diversifying the overall portfolio

The implications of the lower correlations are clear. In addition to getting greater opportunities for active management in a more diversified asset class, investors can add performance to a portfolio of US IG corporate bonds by adding EM IG corporates, while diversifying the overall portfolio.

To quantify the potential improvement from adding EM we estimated the most efficient share of EM IG corporate bonds within such as portfolio to be no less than 97%, given the characteristics of the two asset classes in terms of returns, volatility and correlations based on data going back to 31 December 2003 (figure 5 below).

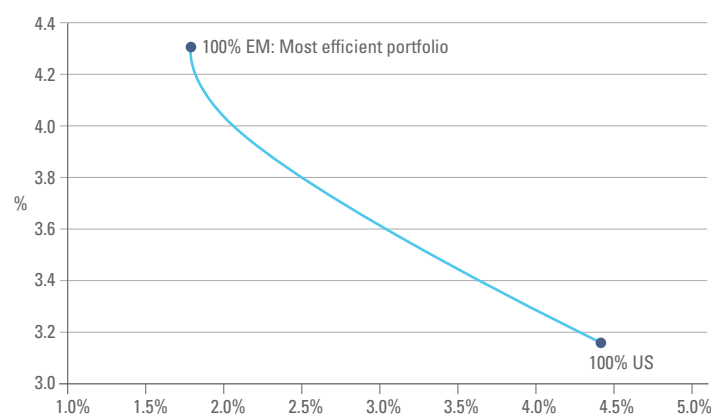
Fig 5: **Efficient allocation to EM IG corporate bonds vs US IG corporate bonds**



Source: BAML, JP Morgan, Ashmore.

However, given the current mispricing of EM if one does the same analysis using 1 year correlations, current yields-to-maturity and 1-year annualised volatility the optimal allocation to EM is 100% as figure 6 shows.

Fig 6: **Current yield to maturity versus 1-year annualised volatility**



Source: BAML, JP Morgan, Ashmore.

The EM IG universe

More than 60% of EM corporate index names are investment grade (USD 784bn). The asset class comprises some 400 issuers across 10 sectors. Between them, these corporates have issued more than 1,000 bonds with an average modified duration of 5.14 years and a yield to maturity of 4.12%. Currently, EM IG corporates trade at a spread of 272bps compared to 164bps for US IG corporate bonds, but there are considerable regional differences across EM with Latin American IG corporates trading at a spread of 355bps (5.05% yield), CEMEA IG corporates at 281bps (4.11% yield) and Asian IG corporates at 203bps over Treasuries (3.52% yield). At these spreads, EM IG corporates pay investors about 60% more spread per turn of leverage than US IG corporates. The asset class is commonly benchmarked to the JP Morgan CEMBI BD IG Index, which covers corporates from 30 countries, more than 300 issuers and has a market cap close to USD 240bn.

The EM IG corporate universe – descriptive statistics

Sector	Number of issuers	Number of bonds	Market value (USD bn)
Financials	129	328	206
Energy	38	172	172
Materials	32	93	66
Agencies/Quasi	36	113	89
Utilities	48	112	72
Real Estate	39	73	42
Telecom	16	56	49
Capital goods	18	50	42
Food	17	33	21
Transport	27	41	25
Total	400	1071	784

Source: BAML, Ashmore.

Conclusion

Financial markets are extraordinarily inefficient. Moreover, this inefficiency has become even more pronounced since the start of QE policies which have stimulated asset prices in developed economies. However, the strong technical bid for developed market fixed income from central banks has now rendered IG corporate bonds in developed economies expensive and increasingly risky, especially versus IG corporate bonds in EM.

Indeed, a rationally invested EM-US IG corporate debt portfolio would today allocate 97% to EM and just 3% to US bonds. Based on current yields to maturity the optimal allocation would be even higher at 100%. This is powerful evidence of mispricing of EM credit versus developed market credit.

Our results call into question the validity of allocating to any part of the US IG Corporates as long as there is always a more profitable, less risky alternative available in EM.

EM bonds are particularly cheap at this time. EM offers not just higher returns with lower volatility, but also compelling diversification benefits by virtue of declining correlations with US corporate bonds and a greater degree of internal diversification.

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