Mar 2017

The What-Why-When-How Guide to Owning Emerging Country Debt: 2017 Edition

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In the full version of this white paper (available at www.gmo.com), we offer our perspective on the frequently asked questions that have come up over the years about emerging debt investing. What follows here is a very brief summary of the key conclusions and questions answered within the paper.

We encourage you to read the full white paper for more answers and analysis.

What are the value, diversification, and alpha propositions of the three major types of emerging debt (external, local, and corporate)?

- ***External debt*** offers *value* when the credit spread is high relative to expected losses, due to the rare sovereign defaults, and when U.S. interest rates are well valued. It has a fairly high correlation with risk assets (S&P, emerging equities) as well as high-grade U.S. bonds, given its association with risky emerging country borrowers and high interest-rate duration. That said, from a fundamental standpoint, it shares no exposures in common with equities or U.S. Treasuries, offering *fundamental diversification* for typical portfolios of stocks and bonds. It offers high alpha potential, with the median manager handily beating the benchmark, and top managers doing extremely well.

- ***Local currency debt*** offers *value* when the currencies are cheap and the real interest rates are high relative to the funding currency. Its correlation with risk assets (S&P, emerging equities) is higher than for external debt, mostly due to the currency volatility effect, but has a lower correlation than external debt to high-grade U.S. bonds, given a lower duration. It shares a fundamental overlap with emerging equities in terms of the currency exposure (although not exactly the same currency basket), but is otherwise a new fundamental exposure in typical portfolios of stocks and bonds. It offers less *alpha* potential than external debt, except for top managers, mostly due to the costs (taxes, custody) of operating in the local markets, where the benchmark is measured gross of fees.

- ***Corporate emerging debt*** offers *value* when the spreads over the relevant sovereign are high relative to expected additional loss (beyond the sovereign). Unfortunately, generally these spreads are too low to compensate for the idiosyncratic default risk. Their correlation with risk assets (emerging equities as well as high yield bonds) are among the highest of the three, given the shared corporate exposure. They do not offer much fundamental risk diversification, since a sovereign default usually triggers a default of all the associated corporates. *Alpha* has been challenging as well.

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How should one own emerging debt? Dedicated external, local, corporate, or blended? Active or passive?

Dedicated external and local portfolios allow the investor to benefit from the alpha opportunities available in each, while also allowing the investor to consider the marginal diversification and value properties of either one, with respect to the investor's current asset mix. Blended products take away this flexibility with typically no additional alpha. Corporate emerging debt offers little alpha and is, in most environments, redundant to typical portfolios of stocks (including emerging equities) and bonds (especially those with global investment grade and/or high yield).

We believe in active management, and we describe in the full paper what is meant by "top-down" and "bottom-up" styles in the emerging debt context. We give reasons why we believe bottom-up (our style, naturally) has a better chance of success.

As for passive, ETFs are not useful as investments, as they come with relatively high fees (relative to the discounts versus active management offered in equity ETFs) and high unintentional tracking error. They also follow reduced benchmarks of more liquid (and therefore more richly valued) bonds. That said, they might be useful as market timing vehicles for those skilled at market timing.

How should one think about liquidity?

In the full paper, we also include analysis of the liquidity of emerging debt. Regulations relating to liquidity have coincided with a secular decline in liquidity in all three segments. This has implications for how collective investment vehicles ought to approach the topic. We conclude: purchase premia/redemption fees (our method) and swing pricing (more common for UCITS) result in the same return outcome (as both shield existing shareholders from the impact of transacting shareholders), but swing pricing introduces NAV tracking error, reducing Sharpe and information ratios relative to our method.