Aberdeen Standard Investments

Investing in Emerging Market Debt

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Introduction

The world is changing – and changing fast. Emerging Markets were once seen as a niche interest for specialist investors. Today, they are one of the dominant engines of global growth. The rise of Emerging Markets is an epochal shift we believe no investor can afford to ignore.

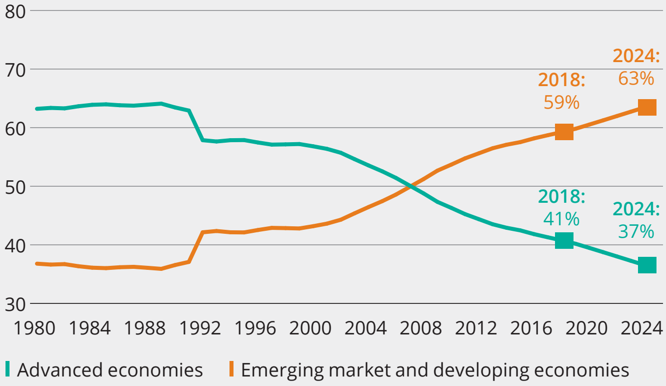
The economic growth of Emerging Markets is driven by powerful structural trends, including favourable demographics, massive urbanisation and the rise of the middle class. On some measures, China is already the world's largest economy, with India the third largest.[1] Meanwhile, the economies of countries like Indonesia, Vietnam and Egypt continue to grow rapidly.

Already, emerging economies make a larger contribution to global GDP than their developed peers. That contribution is set to rise further in the years ahead. Indeed, by 2024, emerging economies are projected to account for 63% of global GDP.[2] Furthermore (as shown on the right), in its latest World Economic Outlook, the International Monetary Fund (IMF), a leading multilateral development bank, estimated the difference in economic growth rates between emerging and developed markets will nearly double over the next five years to 3.3%.

At the same time, while the volume of Emerging Market bonds and the size of the investment opportunity have grown significantly in the past decade, Emerging Market fundamentals remain generally stronger than in developed markets. Of particular note, although increasing, their overall debt level relative to GDP remains considerably lower.

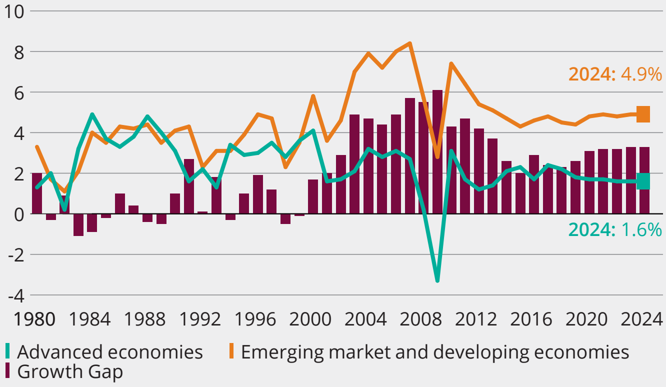
According to the International Institute of Finance, (all sector)[3] total debt in developed markets was equal to 380% of GDP at the end of 2018, compared to 212% for Emerging Markets.

Chart 1: Share of World total GDP based on PPP (%)



Source: International Monetary Fund, World Economic Outlook Database, April 2019.

Chart 2: Gross domestic product, constant prices (% change)



Source: International Monetary Fund, World Economic Outlook Database, April 2019.

1 Purchasing Power Parity basis (PPP).
2 IMF World Economic Outlook, April 2019.
3 Total debt here refers to household, government, non-financial corporates and financial corporates debt.

A large and expanding universe

In total, Emerging Market Debt now represents 28% of outstanding global debt.[4] However there is a big disparity between this and the level of representation in global investor portfolios.

In the Bloomberg Barclays Global Aggregate Index (a leading broad global bond index), the weighting for all Emerging Market Debt is still only 6%, with the combined weighting for China and India being just 2%. This is despite the two countries accounting for around 27%[5] of global GDP at present.

We believe this under-representation cannot last. With markets like China and India making themselves more accessible to international investors, weightings in international bond indices look sure to rise in coming years. Indeed, in China's case, the current weighting of 1.9% is expected to more than triple to 6.0% by the end of 2021, based on the planned phase-in of Chinese securities into the Bloomberg Barclays Global Aggregate Index.[6] Rising index weightings can stimulate both investor interest and inflows, which can offer potential opportunities for forward-looking investors.

"Markets like China and India are making themselves more accessible to international investors."

[4] Institute of International Finance, data as of April 2019.
[5] IMF World Economic Outlook, April 2019.
[6] Bloomberg calculation based on data as of 24 January 2019.

Components of EMD

Emerging Market Debt can be broadly classified into four sub-asset classes, namely hard currency sovereign debt, local currency sovereign debt, corporate bonds and frontier bonds.

Hard currency sovereign debt

This is debt issued by **governments in hard currencies, usually the US dollar**. The yield is typically the US Treasury yield for the maturity period plus a spread to compensate for the additional risk of investing in Emerging Market Debt. As well as offering a yield advantage over developed market yields, hard currency Emerging Market Debt offers diversification benefits – allowing a portion of fixed income exposure to be differentiated from the US, and crucially without any currency risk.

Local currency sovereign debt

As the name suggests, this is **debt issued by governments in their own currency.** Two of the key advantages of this asset class are a potential additional source of return from currency movements and relatively high liquidity stemming from this Emerging Market Debt segment having by far the largest **market value.**

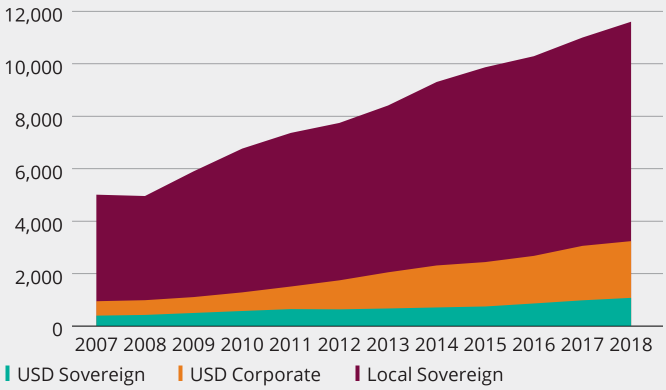
Emerging market corporate bonds

This is debt issued by Emerging Market ***companies*, typically in US dollars.** The key advantage of this segment is the high degree of issuer diversity (over 600 issuers compared to 169 hard currency sovereign issuers), which can improve the scope for portfolio diversification and security selection.

Frontier bonds

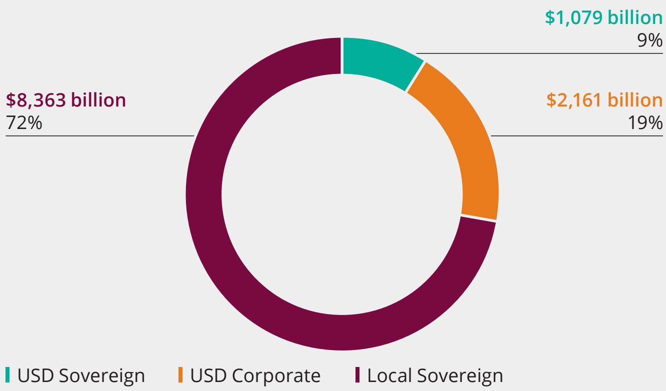
A term coined in 1992 by the International Finance Corporation, 'Frontier markets' are typically smaller emerging markets (of which there are currently 35 in our investible universe) with improving growth dynamics and, in general, sustainable debt levels. Within the JP Morgan NEXGEM index, Frontier markets are usually defined as those issuers with less than 2% exposure in the JP Morgan EMBI Global Diversified Index, with a rating of BB+ or lower and excluding countries engaged in the process of seeking EU membership.

Chart 3: Total EMD market: USD 11.6trn



Source: JP Morgan, 31 December 2018. For illustrative purposes only.

Chart 4: Size of the EMD market by sector



Source: JP Morgan, 31 December 2018. For illustrative purposes only.

Attractive income potential

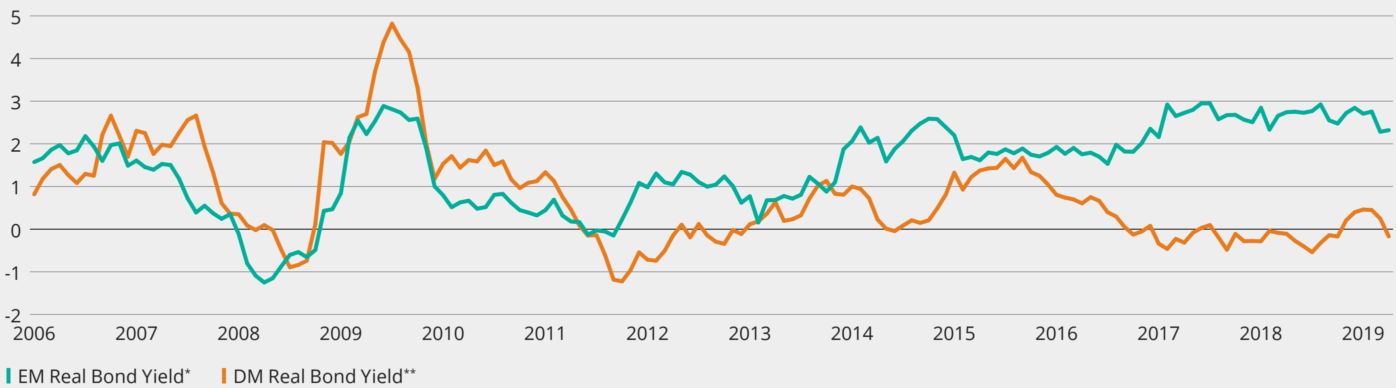
A key attraction of Emerging Market Debt is that it currently provides significantly higher yields in both nominal and real terms (i.e. adjusted for inflation) compared to developed country bond markets.

Indeed, in the context of very low developed country yields, Emerging Market Debt presents one of the few remaining attractive propositions for the ever-growing global cohorts of income-seeking investors.

The sustained yield advantage of Emerging Market Debt can partly be explained in terms of a 'risk premium' – however, while this is partly justified, we think the size of this premium is skewed by a negative perception bias which is also reflected in marked under-representation of Emerging Market Debt in many global investors' portfolios. Crucially, we think the Emerging Market Debt risk premium will reduce over time both as a result of Emerging Markets becoming structurally stronger (and therefore inherently less risky) as well as the increasing dissipation of negative perception biases, as newsflow continues to improve.

"We think the size of this premium is skewed by a negative perception bias."

Chart 5: EMD real yields extremely elevated compared to DM (%)



Source: HSBC, IMF, as of 30 April 2019.
For illustrative purposes only.
* PPP weighted average of Brazil, China, India, Indonesia, Mexico, Poland, Russia, S. Africa and Turkey.
** PPP weighted average of Germany, Japan, UK and the US.

Past performance is not a guide to future results.

Risk and return perspectives

Historically, returns from Emerging Market Debt have been strong, which is true on both an absolute and a risk-adjusted basis. As shown below, over the last 10 years, most Emerging Market Debt segments have provided similar or better annualised returns than Emerging Market equities.

However (less surprisingly given their priority in the corporate capital structure) these returns have come with much less volatility, resulting in higher risk-adjusted returns over the period.

While the risk-adjusted returns for the local currency Emerging Market Debt segment over the last 10 years are noticeably lower, a key explaining factor here is the coincidence of a sustained period of US dollar strength during which it rose by over 20% on a trade-weighted basis.

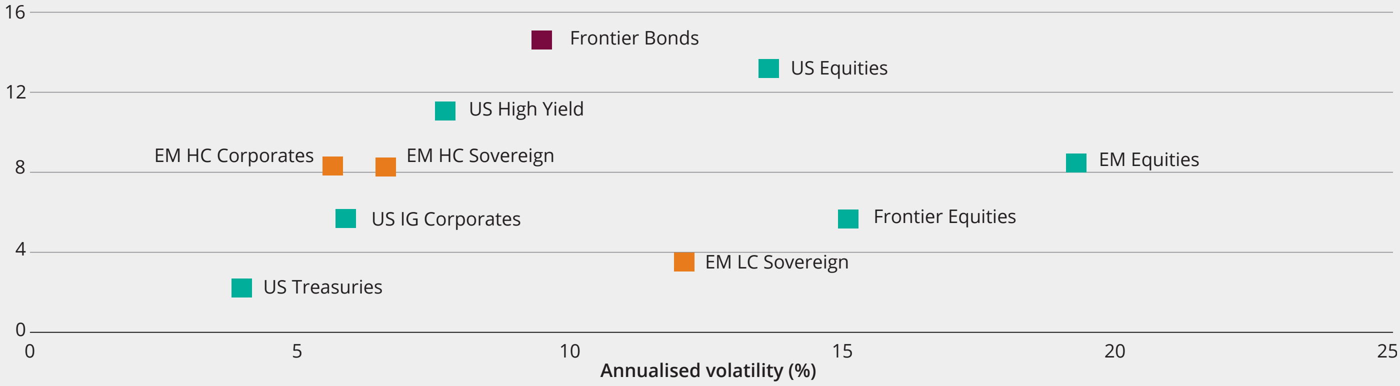
Considering the risk perspective more conceptually, it is clear that Emerging Market Debt has long been considered as a 'high risk' asset class. This probably stems from perceptions that Emerging Market countries are particularly prone to political instability, arbitrary shifts in central bank policy and unsustainable debt levels.

Today, however this simple generalisation looks more questionable. While it is true that political risk remains a bigger factor in Emerging Markets compared to their Developed Market counterparts, the gap has been lessening. Many Emerging Market countries now have independent central banks and more credible policy making.

While a few outlier examples such as Turkey and Argentina will inevitably tend to skew perceptions, the general trend of Emerging Markets has been in the right direction. Ironically, the converse seems to be true in developed markets, where political risk seems to have been growing, as seen with the rise of populism and issues like Brexit.

In the corporate bond segment of Emerging Market Debt in particular, there are some additional considerations that bode well from the risk/reward perspective. A notable attraction of this segment, which has already grown to be at least a third bigger than the US high yield market, is that it can often offer yields that are higher than those available from Developed Market companies with similar credit fundamentals. A key reason for this is that many Emerging Market companies have their bond ratings capped based on the ratings of the countries in which they are based.

Chart 6: Benchmark annualised returns USD (%)



Benchmarks used: US Treasury = JPM GBI US, US IG Corporate = JPM JULI, EM Corporate = JPM CEMBI BD, US High Yield = JPM US HY, EM HC Sovereign = JPM EMBI GD, EM LC Sovereign = JPM GBI-EM GD, EM Frontier = JPM NEXGEM, US Equities = S&P 500, EM Equities = EM Free, Frontier Equities = MSCI Frontier.
Source: JP Morgan, 31 December 2018.
For illustrative purposes only.

Past performance is not a guide to future results.

Diversification benefits

The Emerging Market Debt universe comprises an exceptionally diverse and growing number of assets. It offers exposure to a wide range of countries, companies and sectors.

The JP Morgan Emerging Market Bond Index, for example, includes some 73 countries across five continents, while the Corporate Emerging Market Bond Index provides access to an additional 655 issuers.[7] Aside from dollar-denominated exposure, local-currency Emerging Market Debt offers opportunities through approximately 20 additional currencies and yield curves.

The rapid growth of the Emerging Market Debt investable universe implies a high degree of diversification potential within the asset class. No less importantly, Emerging Market Debt offers an important source of diversification within a broader global bond portfolio. This is because the asset class has traditionally had low correlation to US Treasuries, making it well suited to mitigating interest-rate risk.

"Emerging Market Debt offers an important source of diversification within a broader global bond portfolio."

[7] JP Morgan, 30 April 2019.

Aberdeen Standard Investments for EMD

The importance of ESG

Environmental, social and governance (ESG) evaluation is deeply embedded in our Emerging Market Debt investment process. Aberdeen Standard Investments is a longstanding signatory of the UN Principles of Responsible Investment, underscoring our commitment to best practice in this area.

One of our core beliefs is that intelligent ESG assessment and engagement can deliver better outcomes and can potentially enhance investor returns. Countries and companies that adopt positive ESG behaviours are likely to engage in sustainable business practices which ultimately support their long term economic and financial success. Accordingly, we aim to be an industry leader in ESG, which we see as critical to identifying risks and opportunities that can impact the value of the portfolios we manage on behalf of our clients.

We approach ESG from both the top down and the bottom up. Our global ESG investment research provides top-down thematic and sector insights. In addition, our asset-class ESG research provides us with bottom-up, issuer-level insights. Through this dual approach, we seek to understand how bond issuers manage their strengths and weaknesses – and to what extent this is related to aspects such as climate change, human capital management, supply chain issues and diversity or balance-sheet issues.

Furthermore, as stewards of our clients' capital, we actively seek to engage with companies to promote best practice and better ESG outcomes. We can also apply our sustainability-driven approach to a wide range of specialist strategies to meet clients' specific ethical, socially responsible and thematic (e.g. climate-based) investment goals.

Given the wide range of political systems in emerging-market countries, we incorporate a strong focus on political risks. To this end, we have created a proprietary ESGP (environmental, social, governance and political) framework that we apply to Emerging Market Debt issuers.

Our Central ESG Investment Team, which works on a cross-asset class basis, and fixed income-focused 'ESG Network' are together comprised of 37 ESG investment professionals.[8] This team has deep expertise in each ESG area. The ESG insights delivered by our team inform all our investment decisions. By making ESG evaluation central to our investment capabilities, we look to deliver robust investment outcomes for our clients, while also actively working towards a more responsible and sustainable world.

The value of an active approach in EMD

When it comes to investing in Emerging Market Debt, investors have broadly two alternative avenues available to them: an active approach or a passive approach. In the active case, an investment manager will decide which Emerging Market bonds to buy based on a case-by-case analysis of the credit quality of each issuer and other factors. In the case of a passive approach however, investors' money will be allocated 'automatically' based on the weighting of Emerging Market bonds in indices. In turn, these weightings are based on the market value of each issuer's outstanding debt, relative to the size of the debt of all issuers.

In our view, the case for an active investing approach is particularly strong for Emerging Market Debt due to a number of reasons:

Firstly, in contrast to equities, we think that allocating money based on the market value of debt is fundamentally problematic in all forms of bond investing – quite simply, this is because it implies buying more of the bonds of those countries and companies that have *issued the most debt*.

Secondly, as pointed out earlier, the Emerging Market Debt asset class is remarkably diverse, resulting in considerable dispersion (i.e. variation) in returns for both countries and companies – we think this inherently favours an approach that *actively* considers the relative merits of each investment opportunity.

Thirdly, when it comes to Emerging Market Debt investing, adaptability to changing economic and political conditions can be a significant source of value creation and value preservation. This kind of responsiveness and flexibility is clearly something that is of no relevance to passive approaches.

[8] As at 31 July 2019.

Our team, experience and EMD solutions

Aberdeen Standard Investments is one of the world's largest investment houses. Our scale gives us considerable strength in resources, research and flexibility. We are geographically diverse, with over 40 offices worldwide and investment managers based in over 20 different global locations. This global reach helps to bring us closer to local markets and the companies in which we invest.

Our Emerging Market Debt team is highly experienced, stable and well resourced. We have been investing in Emerging Markets for more than three decades and in Emerging Market Debt for over a quarter of a century. We feel our long-established network in Emerging Market countries provides us with significant advantages in the research and investment process.

Our Emerging Market Debt strategies cover the full spectrum of opportunities: sovereign debt and corporate bonds; mainstream Emerging Markets and frontier markets; and in hard and local currency. This means that we can offer a comprehensive range of Emerging Market Debt solutions. Furthermore, we are well recognised as Emerging Market Debt specialists in both debt and equities, which can give us a wider perspective and potential research benefits.

As country selection is critical to investing in Emerging Market Debt, our team carries out extensive research in both mainstream and frontier markets. We cover over 80 countries and carry out at least 50 country visits each year. Our corporate team also has meetings with the managers of more than 700 companies annually and covers over 500 companies in depth.

All of these factors help us deliver comprehensive EMD investment solutions for our clients.

To find out more about our Emerging Market Debt capabilities, please speak to your local Aberdeen Standard Investments representative.

Experience
Long history of investing in EM

Resources
Local presence and experienced team

Research
Intensive bottom-up approach

ESG
Analysis on all issuers covered

Risk
Focus on downside protection

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Emerging markets: Emerging markets or less developed countries may face more political, economic or structural challenges than developed countries. This may mean your money is at greater risk.

Diversification: Diversification does not necessarily ensure a return or protect against a loss.

This is not a complete list or explanation of the risks involved and investors should read the relevant offering documents and consult with their own advisors investing.

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