Emerging-Markets Debt Moves into the Spotlight

April 2013

Alex Kozhemiakin of Standish suggests accessing the potentially rewarding areas of the emerging markets through fixed-income assets

Many investors and advisors think about emerging-markets bonds only in the context of a comparison to high yield—or riskier—fixed income, says Alex Kozhemiakin, Emerging Markets Debt Team Leader at Standish Mellon Asset Management and co-portfolio manager of the Dreyfus Emerging Markets Debt Local Currency Fund (DDBAX). Yet this asset class presents a more varied set of risks and rewards than typical junk bonds do. Kozhemiakin—who invests in the entire spectrum of emerging-markets debt, including dollar-denominated bonds, local-currency-denominated bonds and both sovereign and corporate debt—says the best balance of risk and potential reward in emerging-markets debt today is found in countries with relatively low geopolitical risk. In a recent conversation with Morgan Stanley Wealth Management’s Tara Kalwarski, he discussed some of the most attractive plays in this sector right now. The following is an edited version of their conversation.

Kalwarski: Can you define the universe of emerging-markets debt you consider?

Kozhemiakin: Most of the countries that we call emerging markets have one characteristic in common: They are not yet rich. You define how rich a country is by its per-capita gross domestic product, otherwise known as per-capita GDP. As a rule of thumb, if a country’s GDP per capita is not in the upper quartile, it is not rich.

Thus, I say that we invest in the fixed-income asset classes of non-rich countries. If you phrase it this way, the risks, as well as the return potential, of investing in emerging markets become more apparent. By definition, non-rich countries are starting with a lower base and thus have the potential to grow at higher rates than developed rich countries do. Mexico’s future growth rate is likely to be higher than that of the U.S., Russia has more potential to grow than Germany. Then you consider why these [non-rich] countries aren’t rich yet. Defining that aspect helps enumerate the risks of investing in emerging markets—such as the weaknesses of some of their institutions, macroeconomic volatility or dependence on a single commodity.

Kalwarski: How do you determine whether or not the potential returns are worth the risks?

Kozhemiakin: We look at the usual fundamental factors, such as the global macroeconomic environment and a specific country’s balance sheets and income statements, as well as the political situation.

What distinguishes the fundamental research in emerging markets from [research aimed at] U.S. corporates is the importance of country risk. Our real bread and butter is country picking—we have to select our countries correctly.

This applies to emerging markets corporate debt as well. We liken picking emerging markets corporate bonds to buying houses—you have to like both the “house” and its “neighborhood.”

Kalwarski: What countries are you bullish on at the moment?

Kozhemiakin: For the past year we have been bullish on Mexico. We have chosen to express this view with our long position in the Mexican peso against the U.S. dollar. There are a number of reasons for this. One of them is the
fundamental valuation of the Mexico peso; it's been a cheap currency, and we still think it’s cheap.

Second, Mexico’s growth rate has remained relatively strong while inflation has been fairly subdued. With the new president, there is an expectation that Mexico could embark on the necessary structural reforms to boost the long-term growth rate of the economy.

So you’ve got a reasonable growth rate, the potential for structural reforms, an undervalued currency, responsible monetary policy and well-behaved inflation—in an environment where there is no reason to question the public-debt sustainability. All those things, combined with a relatively favorable balance of payments for the Mexican peso, helps explain why we are bullish in Mexico and why we have used the currency to express this view.

We’re also overweight in the Chilean peso. Chile is a very well-run country. It has a high growth rate, reasonable monetary policy and low debt. That said, there is a risk there; Chile is a major exporter of copper. So we are also keeping an eye on developments in China, particularly in the property sector, for the potential swings in the demand for copper.

In the East European region, we like Russia. We’re exposed to that country through its currency as well. While Russia has institutional weaknesses, its sovereign creditworthiness is not in doubt. We can buy Russian local-currency-denominated debt with a shorter duration at the yield approaching 7%, which is quite attractive to us. The Russian ruble is also a bet on oil prices, and currently, oil and gas remain very important for Russia from a fiscal, as well as an export, standpoint.

We do not have any Middle Eastern exposure in our portfolio because of the geopolitical risks related to Iran. But we can actually play these tensions to our advantage, as they are keeping a floor on oil prices. Russia is a country through which we’re expressing this view.

Kalwaski: In dollar-denominated debt, are you finding better opportunities in sovereign- or corporate bonds?

Kozhemiakin: There are still some good opportunities in sovereign debt, but the days of significant spread compression are over. In general, we have shifted more toward quasi-sovereign and corporate debt. We’re finding good opportunities in Mexican, Colombian and Peruvian corporates. In Russia, given the concerns about institutional weakness and the protection of private property rights, we prefer to play the story via quasi-sovereigns.

Kalwaski: What areas or countries don’t look very attractive right now?

Kozhemiakin: We do not believe that political risks are fully priced into the Middle East, so we have no exposure there. We avoid countries with weak institutional frameworks—such as Belarus, Belize, Jamaica and Pakistan. We are also generally cautious on Central Europe, partially as a result of its greater vulnerability to the European debt crisis.

Kalwaski: Do you have other strategies to help mitigate overall portfolio risk?

Kozhemiakin: Above all, we consider the global macroeconomic environment. If we get a sense of volatility in a country, we seek to hedge out some of the currency risk in the local currency. In our dollar-denominated debt portfolios, we sell some of the high-yielding exposure.

We also aim to be humble. If we have a high conviction about a trade, we're going to express it in the portfolio. But we'll still diversify and try to seek returns from a variety of sources rather than betting the farm on one or two or three big trade ideas.

Kalwaski: Why do you think it’s important to consider exposure to emerging-markets debt in addition to considering equity?

Kozhemiakin: There are a couple of reasons. One is simple country diversification. When you’re investing in emerging-markets equities, you’re not investing in quite the same countries as when you’re investing in emerging-markets fixed income. For example, India, China, South Korea and Taiwan are not that heavily represented in the emerging-markets fixed-income universe—for regulatory and other reasons. Peru, Colombia, Kazakhstan and Lithuania on the other hand, do not really have a liquid equity markets but [have] fixed-income opportunities.

Second, in a lower-growth environment, I think you want to be in fixed income. Look at the relative performance of emerging-markets fixed income relative to equities over the past couple of years. If you look at longer time periods, the emerging-markets fixed income has provided better risk-adjusted returns—and in some cases better absolute returns. Clearly there are risks in this asset class, but they’re often different types of risk.
Kalwarski: A lot of money has flowed into this area in the past couple of years. Has that distorted valuations?

Kozhemiakin: I think the rush into this asset class may be more of a problem five to seven years down the road. In the immediate term, I’m encouraged by the fact that a lot of allocations are coming from investors who have a longer-term time horizon: institutional pension plans, sovereign wealth funds and central banks, some of which are located in emerging-markets countries themselves. These investors are looking for a way to diversify away from the U.S., away from the U.S. dollar. Moreover, at least two-thirds of emerging-markets local currency bonds are still in the hands of local investors. Foreigners are still discovering this asset class, and I think there is more room to add.

Kalwarski: Does this type of exposure add significant risk?

Kozhemiakin: Ultimately, emerging markets debt is a risky asset class, in part because there are two types of risks: risk that is inherent to the asset class and the country risk. When U.S. high yield [bonds], the S&P 500, and Germany’s DAX are doing poorly, emerging-markets debt has historically done poorly, too. And countries have risks of their own. You could have something political happen in Russia, for example, or drug violence in Mexico or a collapse of real estate prices in China that would drag Chinese stocks with them.

But the idea here is to diversify. And right now, if you want to diversify your fixed-income exposure overseas, current valuations suggest that the opportunities in Japan or Europe are not that great. That’s why we look at opportunities in non-rich countries. True, you take on different types of risk, but risk avoidance is also return avoidance. Our strategy offers investment-based diversification, and there is the potential of strong returns on the back of better growth rates.
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Diversification does not assure a profit or protect against loss in declining financial markets.

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EMD credit quality source: JP Morgan.

Risk-adjusted and absolute return source: FactSet, for period between 2001 through 2012. Based on the total return comparison of the J.P. Morgan GBI-EM Global Diversified Index versus the MSCI Emerging Markets (Equity) Index. Risk measured by standard deviation, a statistical measure of the degree to which an individual portfolio return tends to vary from the mean, based on the entire population. The greater degree of dispersion, the greater degree of risk. In mutual funds, the standard deviation tells us how much the return on the fund is deviating from the expected normal returns. Past performance is no guarantee of future results.

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Tracking No. 2013-PS-280 4/2013

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