Mastering Emerging Market Debt

For Professional Clients only

Willis Towers Watson

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What do Africa, Latin America, Central Europe, the Middle East and Asia have in common? Very little. And yet investments in emerging market debt (EMD) remain dominated by broad, generalist funds that seek to span all of these areas and require a manager to possess skill in currency, country, and companies of all sectors and a huge span of completely different investments. Perhaps unsurprisingly, the chance of any single manager having all of these skills is very small.

When assessing the value-add that EMD managers have delivered, our analysis[1] reveals that meaningfully less than 50% of the universe have achieved positive returns above benchmark even before fees are taken off (over five, seven and ten year periods). That number drops to closer to 20% when adjusted for all fees and expenses. And thus, counterintuitively for an asset class with huge potential for mispricing and opportunity, asset owners have been continually disappointed.

The case for revisiting the status quo in EMD is increasingly strong. The emerging world is a large and growing part of the global economy, just take China's growing dominance of the news, global growth and trade in the last few years. EMD is consequently an ever more important asset class with ever larger allocations from asset owners and continuing attractive return potential. Now is the time to take another look at this asset class.

[1]Analysis is based on annualised alpha of USD denominated strategies in the eVestment 'All Emerging Mkts Fixed Income' universe, excluding strategies where the benchmark is not available or not appropriately comparable to portfolio holdings or is cash based.

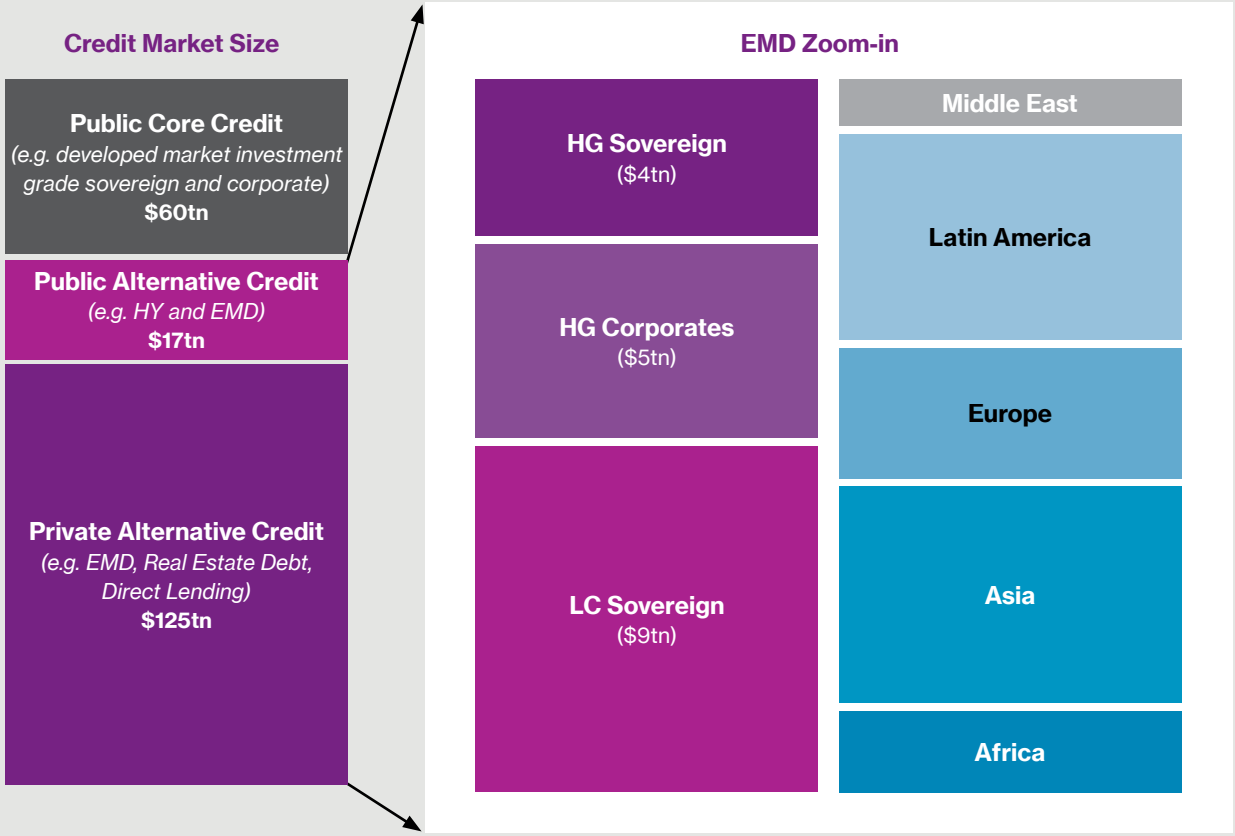
Not one opportunity, but many

EMD is not just one opportunity, but many. While most investors have previously treated EMD as a single asset class, it is really, at least, three distinct asset classes and a large number of very different regions with little in common.

Investors keen to exploit the return potential and in-built diversification offered in emerging market debt must recognise that local currency (LC) sovereign, hard currency (HC/dollar denominated) sovereign and corporate debt are distinct components. Furthermore, each area requires a particular skill set. For example, an investment in LC sovereign debt is dominated by currency risk while an investment in HC sovereign debt will focus more on sovereign credit worthiness and willingness to pay.

Beyond this, each region and group – Asia, Latin America, Frontier markets and Emerging Europe and the Middle East have distinct characteristics. Emerging market debt is an area where on the ground resource, diverse teams, operating in the correct time zone and language specialism can be hugely rewarding in terms of end risk and return numbers. This very much challenges the traditional approach of a single manager based in London or New York.

Figure 1. **Credit market breakdown**



Source: Willis Towers Watson estimates as at December 2017. Bank of International Settlements, Bloomberg LLP CBRE, Dow Jones Brookfield, DTZ Investors, Ellington, JPMorgan, Lazard, McKinsey Global Institution, MetLife, Orchard, S&P Dow Jones Indices, Schroders and U.S. Securities and Exchange Commission.

Favour specialist implementation

Historically, many investors bought a simple, benchmark focused EMD manager who invested across asset classes and countries. This is a widely available strategy and offers an 'easy fix' for EMD.

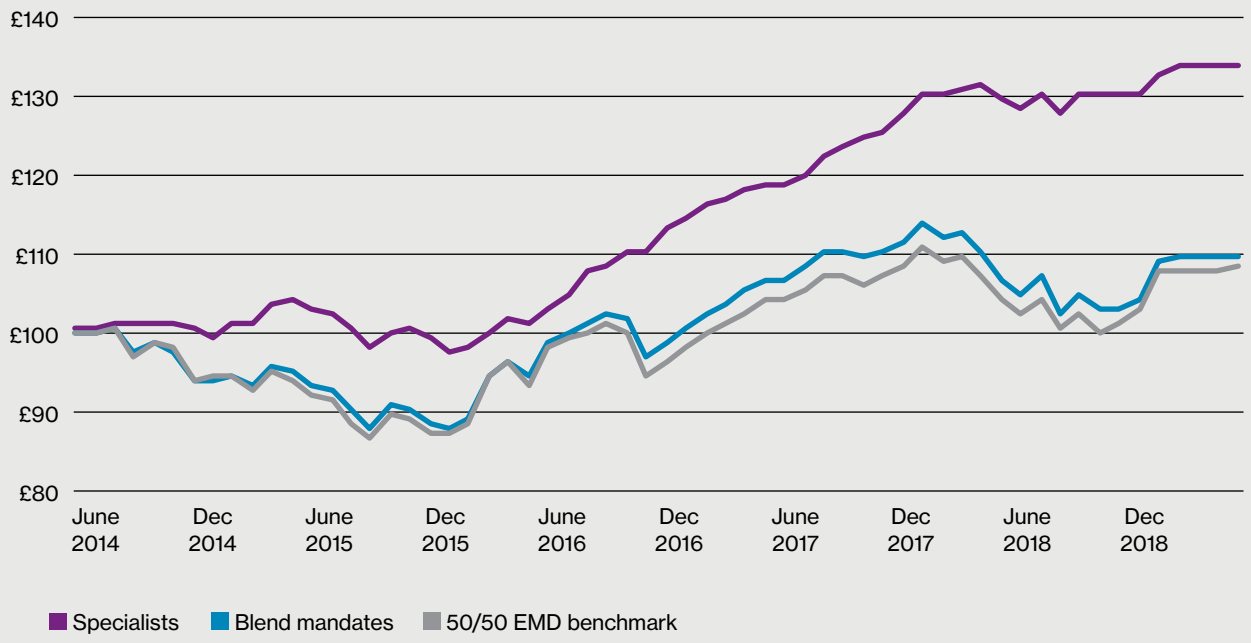
However, as noted above, in general these managers ultimately offer little value add to justify the costs. The majority of managers are very large, developed market based in terms of location and team and struggle to cover the huge breadth of potential opportunities in sufficient depth. Some others attempt to add value in every potential way; we typically find the managers lack the right skills or expertise for every component of EMD. As the famous quote alleges "a jack of all trades is a master of none".

What needs to change? Specialist implementation, i.e. picking the best manager in each area, delivers better outcomes for asset owners, effectively building a portfolio comprised of a "master" in every area.

We believe EMD has much more return potential and downside protection if you select the right specialists. To improve upon a broad blended mandate, investors can implement an EMD allocation via a specialist in each component, e.g. a Latin American corporate specialist with a strong credit analysis skill set or a local currency specialist focussed on rates and FX.

Figure 2 demonstrates the benefits of an approach blending a diversified group of specialists. While the track record remains short, there is a clear improvement in downside protection, a notably higher Sharpe ratio and stronger overall returns.

Figure 2. **Cumulative returns of EMD managers (net of fees)**



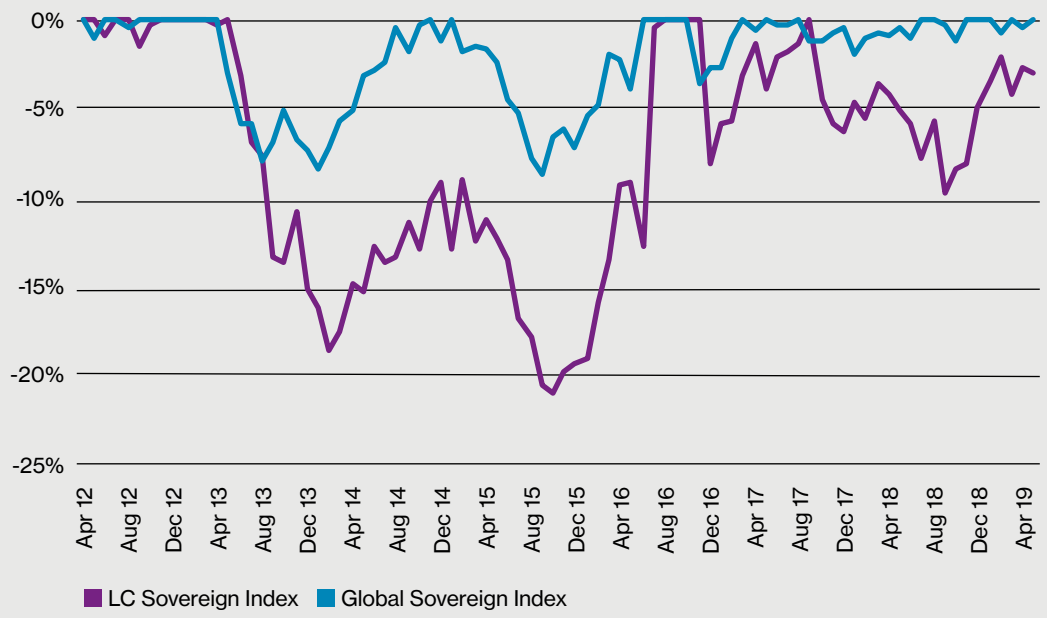
Source: Figure 2 shows the growth of £100 over 5 years as at May 2019. "Specialists" is an equally weighted static allocation to our preferred EM debt specialists. "Blend mandates" uses the average returns of our preferred blend managers. "50/50 EMD Benchmark" is a combination of 50% JP Morgan GBI-EM Broad Diversified Index and 50% JP Morgan EMBI Global Diversified Index. Source: Investment Managers, eVestment

Beware the volatility of Local Currency EMD

LC sovereign debt is the largest, most liquid and highest potential returning component of EMD. However, it is also a volatile asset class. Willis Towers Watson had found that most LC managers do little to protect investors from drawdowns. This is particularly troublesome in stressed markets where increased correlation among EM currencies overwhelms the case for country selection.

To address these issues, Willis Towers Watson created a "Global Sovereign" mandate in conjunction with various asset managers. This gives skilled managers the tools to move 'risk off' and reduce drawdowns through owning safe haven bonds, for example US government bonds, when they see increased risk ahead. Our best-in-class Global Sovereign managers have outperformed benchmarks and the peer group of LC managers over 5 and 7 years.

Figure 3. **Drawdowns in local currency sovereign indices**



Notes: "LC Sovereign Index" is JPM GBI-EM Global Diversified, GBP unhedged. "Global Sovereign Index" is Bloomberg Barclays Global Sovereign Index, £, partially hedged. Source: Bloomberg, eVestment

N.B. Past performance is not a reliable indicator of future returns

Dealing with the governance burden

EMD increasingly demands a larger and more thoughtful allocation from asset owners, often creating a need for appointing multiple managers and increasing the governance burden. Willis Towers Watson is focussed on finding and implementing the best strategies in this area on behalf of our clients, seeking to meaningfully improve alpha whilst keeping fees low. We offer solutions for a variety of governance budgets; whether through pooled funds, bespoke solutions incorporating multiple specialists or line-ups with fewer manager appointments.

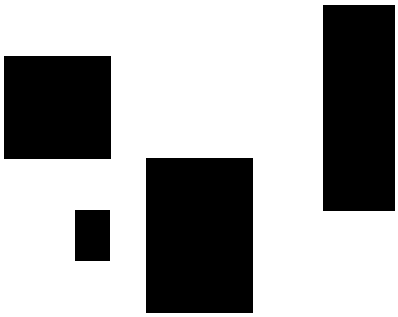
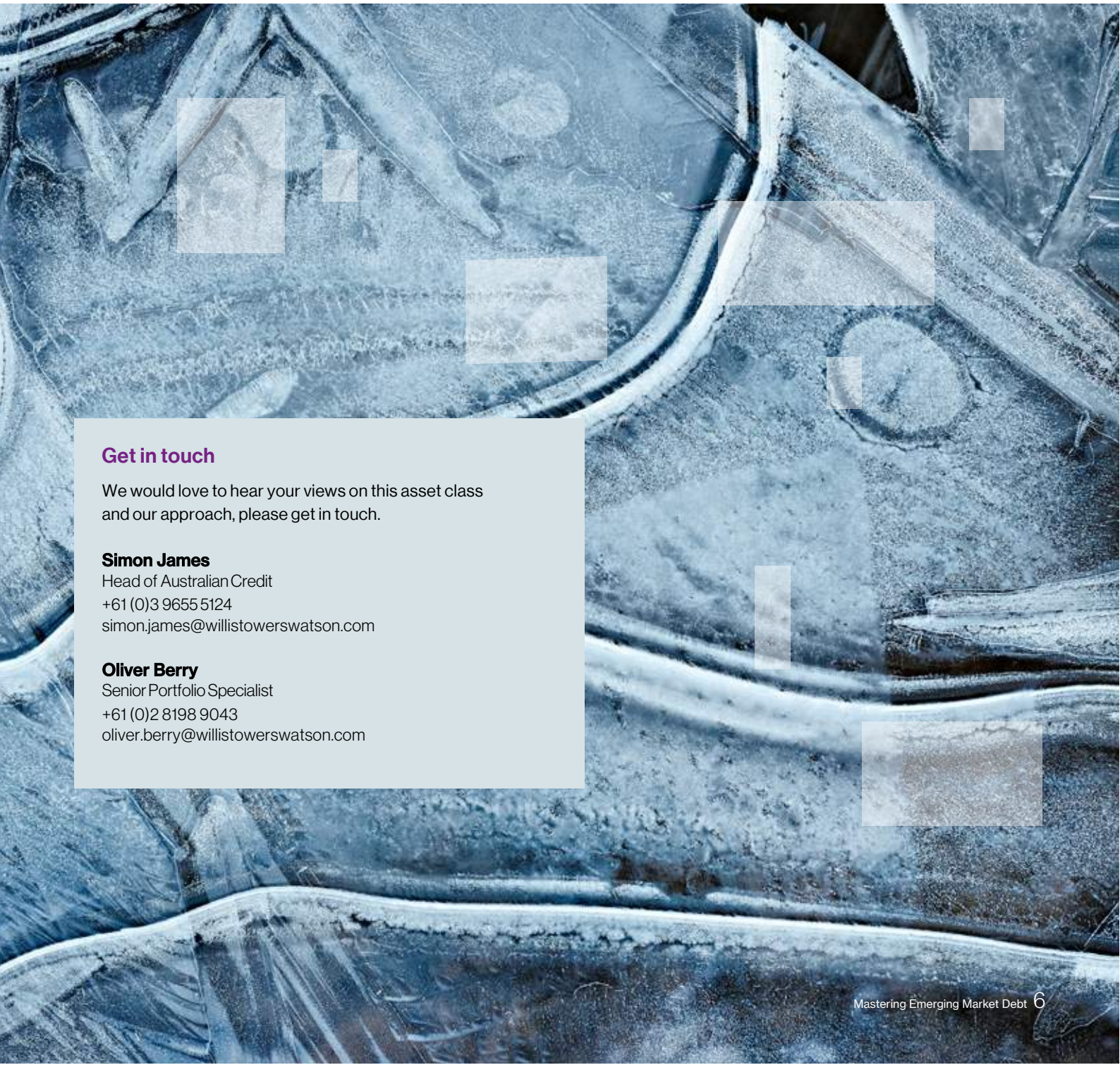


Figure 4. **Bringing together expertise – a snapshot of Willis Towers Watson's specialist implementation model**

Now is the time to rethink your EMD allocation

On average, investors have historically been let down by active investment approaches in EMD. As the asset class rapidly gains strategic importance in global markets and investor portfolios, we believe now is a great time to revisit EMD allocations.

We are excited about the strong returns and diversification benefits EMD can offer. However, EMD is not a single opportunity so cannot be captured by a single, broad mandate. Willis Towers Watson continuously works to find or create best-in-class specialist mandates in each underlying component of EMD. Bringing together these "masters" maximises net return potential, mitigates downside risks and retains attractive asset class returns.



Get in touch

We would love to hear your views on this asset class and our approach, please get in touch.

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About Willis Towers Watson

Willis Towers Watson (NASDAQ: WLTW) is a leading global advisory, broking and solutions company that helps clients around the world turn risk into a path for growth. With roots dating to 1828, Willis Towers Watson has 45,000 employees serving more than 140 countries and markets. We design and deliver solutions that manage risk, optimise benefits, cultivate talent, and expand the power of capital to protect and strengthen institutions and individuals. Our unique perspective allows us to see the critical intersections between talent, assets and ideas — the dynamic formula that drives business performance. Together, we unlock potential. Learn more at willistowerswatson.com.

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