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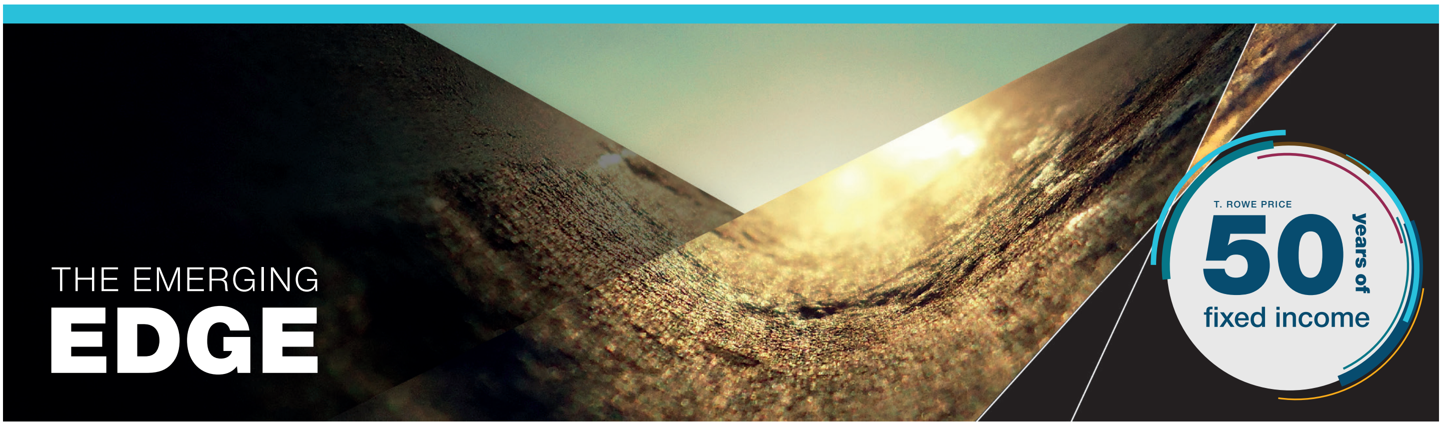
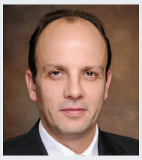
Case study: Romania 2011 – 2015

Exploiting the life cycle of an EM opportunity





Peter Botoucharov
Sovereign analyst

In 50 years of fixed income investing, we have watched a succession of new markets develop from their infancy. One thing we've learned is that emerging market (EM) opportunities tend to follow a recognizable life cycle as countries enter different phases of their economic and capital market development.

As the fixed income opportunity changes, so do the analytical skills required of investors. In the early stages, it's all about sovereign credit risk. As time goes by, macroeconomic and idiosyncratic company analysis are needed, and it increasingly makes sense to combine different analytical skill sets – as illustrated by our first five years investing in Romania.

Early-stage reform and recovery: hard currency sovereign debt

Romania joined the European Union in 2007, but progress was slow in implementing the reforms required for euro convergence. The problems were more than just monetary and fiscal: policy making had been impeded by political in-fighting, vested interests and significant oligarch ownership in some industries.

By 2011, however, we were starting to see more progress, not just with economic policy but also in areas such as judicial reform, anti-corruption measures and the rule of law. The Emerging Markets Debt team initiated a position in Romania's dollar denominated sovereign debt.

Policy reform consolidating: local currency sovereign debt

In 2012, we started looking at Romania's local currency government debt market. Hard currency government debt investing is largely about assessing sovereign credit risk. Moving into local currency debt is a vote of confidence (and a step-up in complexity) because it takes a macroeconomic view on the currency and the interest rate outlook and the ability of the monetary authorities to maintain macroeconomic stability and keep inflation under control.

At the time, Romania was still outside the emerging market bond indices, so it was relatively under-researched. Its 10-year leu-denominated bonds were yielding about 6.5%. Romania was a sub-investment-grade issuer, but this was a hefty risk premium over more advanced peers such as Poland and Hungary, which were trading closer to 2.5%. We believed that the market was overpricing the risk. The 2012 field trip confirmed our investment thesis, and by 2015 we would become the largest non-resident holder of the local currency bonds.

Romania entered the indices in 2013 and was upgraded to investment grade by S&P in 2014. The 10-year bonds we bought in 2012 stayed in our portfolios until 2017.

Corporate sector gains access to credit markets: corporate bonds

By 2013, the Romanian opportunity was an increasingly frequent topic of conversation between the EM debt team and the Global High Yield team. This prompted a joint research trip of sovereign specialists and high yield counterparts from the Baltimore and London offices. Among the first names they invested in was telecom holding company Digi Communications, which can still be found in our portfolios today.

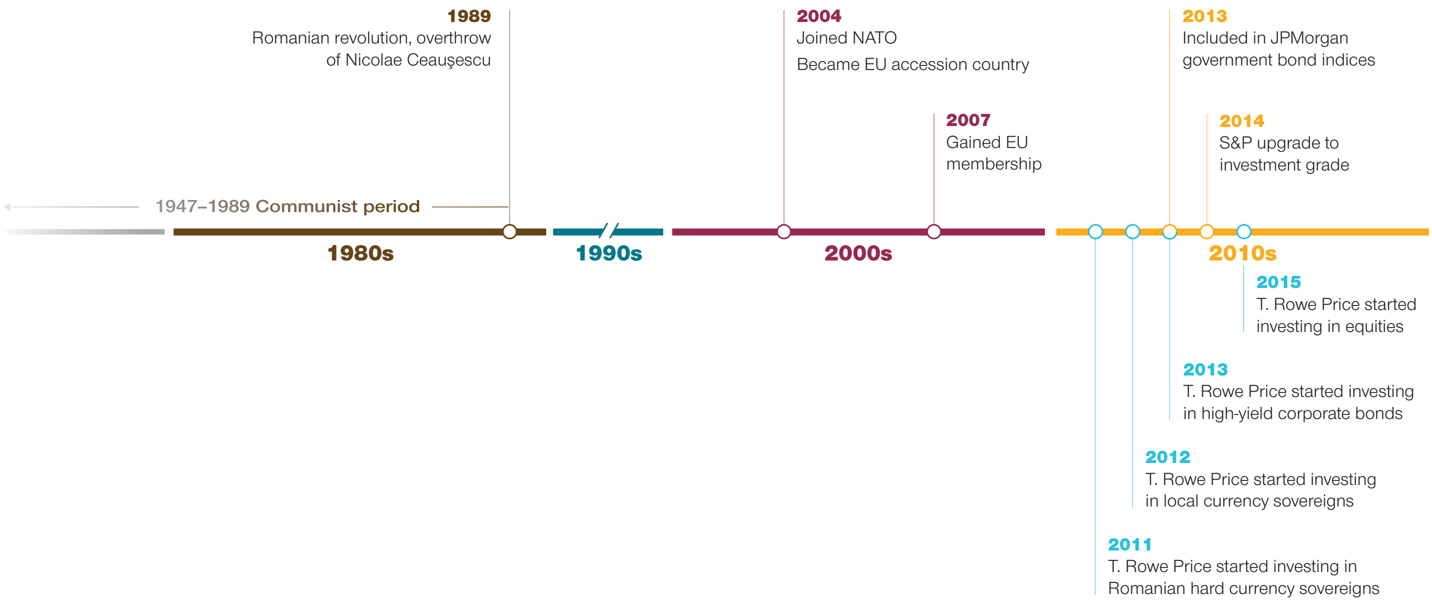
Economic growth on the upswing: equities

By 2015, Romanian sovereign bond spreads had been steadily tightening for five years, and the deep-value opportunity had largely been realized. By contrast, the equity team saw their cue to start coming in and the 2015 field trip was a collaboration between the EM Debt team and our equity counterparts.

At this point, the Romanian economy was emerging from a rough patch, growth and domestic consumption and credit were starting to come back on stream, and the equity team were interested in banking and consumer-driven companies. Two names they bought following that trip – Banca Transilvania and Fondul (an investment company) – are still held in emerging markets equity portfolios.

The future is multidisciplinary

Every country is unique, so investment life cycles don't always follow the same order. For example, often the equity opportunity develops before the corporate bond market. But one constant, in our experience, is the usefulness of a multidisciplinary approach. On the 2015 trip, our EM debt specialists were able to introduce equity and high yield credit peers to economics and finance ministry officials who, for example, can be a useful source of information on which industry sectors are in line for funding, tax breaks or government guarantees. Collaboration between the equity and high yield credit teams, with their different ways of thinking, offers valuable perspectives. Even for our macro team, equity colleagues' access to company management can offer specialist insights on areas such as the economy and the tax structure.



The following risks are materially relevant to the portfolio:

Contingent convertible bond risk - contingent convertible bonds have similar characteristics to convertible bonds with the main exception that their conversion is subject to predetermined conditions referred to as trigger events usually set to capital ratio and which vary from one issue to the other. **Country risk (Russia and Ukraine)** - in these countries, risks associated with custody, counterparties and market volatility are higher than in developed countries. **Credit risk** - a bond or money market security could lose value if the issuer's financial health deteriorates. **Currency risk** - changes in currency exchange rates could reduce investment gains or increase investment losses. **Default risk** - the issuers of certain bonds could become unable to make payments on their bonds. **Derivatives risk** - derivatives may result in losses that are significantly greater than the cost of the derivative. **Emerging markets risk** - emerging markets are less established than developed markets and therefore involve higher risks. **Frontier markets risk** - small market nations that are at an earlier stage of economic and political development relative to more mature emerging markets typically have limited investability and liquidity. **High yield bond risk** - a bond or debt security rated below BBB– by Standard & Poor's or an equivalent rating, also termed 'below investment grade', is generally subject to higher yields but to greater risks too. **Interest rate risk** - when interest rates rise, bond values generally fall. This risk is generally greater the longer the maturity of a bond investment and the higher its credit quality. **Issuer concentration risk** - to the extent that a fund invests a large portion of its assets in securities from a relatively small number of issuers, its performance will be more strongly affected by events affecting those issuers. **Liquidity risk** - any security could become hard to value or to sell at a desired time and price. **Sector concentration risk** - the performance of a portfolio that invests a large portion of its assets in a particular economic sector (or, for bond portfolios, a particular market segment), will be more strongly affected by events affecting that sector or segment of the fixed income market.

General portfolio risks - to be read in conjunction with the portfolio specific risks above.

Capital risk - the value of your investment will vary and is not guaranteed. It will be affected by changes in the exchange rate between the base currency of the portfolio and the currency in which you subscribed, if different. **Counterparty risk** - an entity with which the portfolio transacts may not meet its obligations to the portfolio. **ESG and Sustainability risk** - may result in a material negative impact on the value of an investment and performance of the fund. **Geographic concentration risk** - to the extent that a portfolio invests a large portion of its assets in a particular geographic area, its performance will be more strongly affected by events within that area. **Hedging risk** - a portfolio's attempts to reduce or eliminate certain risks through hedging may not work as intended. **Investment portfolio risk** - investing in portfolios involves certain risks an investor would not face if investing in markets directly. **Management risk** - the investment manager or its designees may at times find their obligations to a portfolio to be in conflict with their obligations to other investment portfolios they manage (although in such cases, all portfolios will be dealt with equitably). **Operational risk** - operational failures could lead to disruptions of portfolio operations or financial losses.

Important Information

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