



# Blending EM Equity and Debt

Three benefits of a multi-strategy approach to emerging markets

August 2019

## KEY INSIGHTS

- A multi-strategy approach to EM investing offers three main advantages. First, it diversifies risk by blending different risk exposures.
- Second, it offers the opportunity to obtain more durable alpha.
- Third, it enables investors to combine bottom-up security selection and top-down management.



**Yoram Lustig**  
*Head of Multi-Asset Solutions, EMEA*

Emerging market (EM) stocks and bonds may sit on opposite sides of the equity/debt divide, but that does not mean they should be treated as if they do. EM debt is a growth (risk) asset that has more in common with stocks than with government bonds of developed countries and, as such, should be considered alongside EM equities rather than placed in a separate bucket. Multi-strategy approaches that incorporate both EM equity and EM debt offer three important advantages over single-strategy approaches.

## Blending Risk Exposures

The first advantage of a multi-strategy approach to emerging markets is that it blends different risk exposures. EM countries have the potential for their economy to grow quickly and make rapid social gains; they can also be at risk of sudden economic downturn or debt default. EM equity and debt are therefore “high octane” investments

that offer both higher possible rewards and greater possible risks than their developed market equivalents. As such, it makes sense to diversify exposure to emerging markets across EM stocks and the three main types of EM bonds: EM hard currency debt, EM local currency debt, and EM corporate debt.

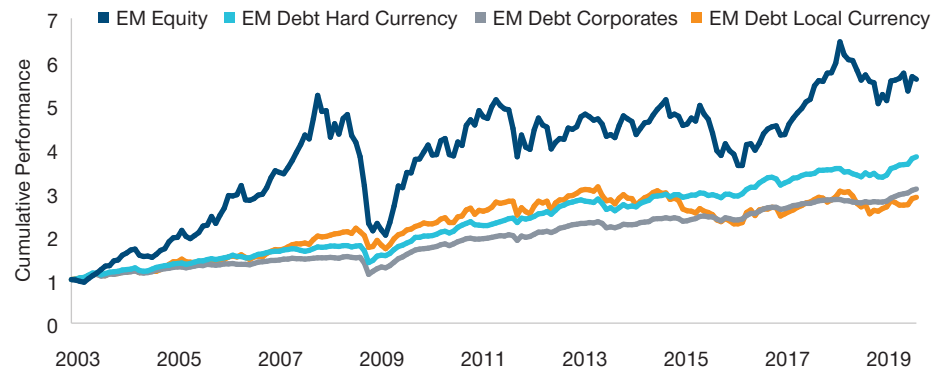
While these four types of EM investments share some characteristics, they remain distinct asset classes, with clearly differentiated behaviors and performance (see Fig. 1). Returns of EM equities and local currency bonds, for example, tend to be driven by EM economic growth, monetary policies of EM central banks, inflation, and currency movements; returns of EM hard currency debt are chiefly determined by the U.S. dollar and the actions of the Federal Reserve; and returns of EM corporate debt are derived not only from macro factors, but also from micro and industry-specific factors. Correlations between the four asset

“EM debt is a growth (risk) asset that has more in common with stocks than with government bonds of developed countries...”

“Emerging markets typically offer more opportunities to generate alpha than developed markets because they are less efficient, less well researched, and frequently come with a liquidity premium.

### (Fig. 1) Differentiated Exposure

The four main types of EM investments are distinct asset classes. January 2003 through July 2019. Returns measured in U.S. dollars.



#### Past performance is not a reliable indicator of future performance

Sources: T. Rowe Price calculations using data from FactSet Research Systems Inc. All rights reserved. EM Equity: MSCI Emerging Markets Index, EM Debt Hard Currency: J.P. Morgan EMBI Global TR, EM Debt Corporates: JPM CEMBI Broad Diversified, EM Debt Local Currency: JPM GBI-EM Global Diversified.

classes are imperfect and can shift depending on what is happening in the broader economy. Blending them, therefore, provides diversification of risk factors, including local currencies, inflation levels, central bank policies, and industry-specific issues.

Further risk diversification is provided by the opportunity to invest across the whole capital structure of issuing corporations. An investment strategy that includes both an EM company's stocks and bonds will disperse risk more widely than one focused solely on either.

#### Finding Durable Alpha

The second benefit of a multi-strategy approach to emerging markets is that it provides the opportunity to obtain “durable alpha.” Emerging markets typically offer more opportunities to generate alpha than developed markets because they are less efficient, less well researched, and frequently come with a liquidity premium. However, as with any other asset class, it requires manager skill to identify and extract this alpha. Blending different strategies managed by different portfolio managers, even if they work for the same firm, provides exposure to a greater range of manager skill and is

therefore more likely to deliver consistent alpha than relying on a single strategy managed by a single manager alone.

Range and diversity are important here. While blending only two strategies (say, EM equities and EM hard currency debt) may result in periods of underperformance, adding EM local currency and corporate bonds to the mix will make this less likely—the wider the range of managers, the less impact it will have when individual managers struggle to generate alpha at any one time, or even if the asset class as a whole is struggling.

Correlations clearly matter too. A group of EM managers generating alpha returns that move in tandem will be less beneficial than a group whose alpha returns are less correlated. It is possible to predict how correlated different managers' alpha returns will be by undertaking a qualitative analysis of their respective philosophies, approaches, and holdings and then comparing them with their ex-post returns. The less correlated the alpha, the more durable it will be for the blend.

“Investors can combine bottom-up alpha generation with top-down management techniques to build EM portfolios of various risk profiles.

### **Adding Top-Down Management**

The third major advantage of combining EM equity and debt in a multi-strategy approach is that it enables investors to combine top-down management with bottom-up alpha generation. The bottom-up approach described above is focused on selecting securities across the broad spectrum of EM equities and bonds. Adding top-down management makes it possible to also incorporate active currency management and dynamic tactical allocation among the various EM equity and EM debt sub-asset classes.

Investors can combine bottom-up alpha generation with top-down management techniques to build EM portfolios of various risk profiles. The first step to achieving this is to formulate capital market assumptions (specifically with regard to returns, volatility, and correlations) for EM equities and the three types of EM bonds; the second step is to plot the four asset classes along the efficient frontier. Once the risk/return correlation profile of each EM asset class is established, they can be combined to form portfolios with different characteristics.

A lower-risk profile, for example, might comprise 50% EM hard currency debt,

30% EM corporate debt, and 20% EM local debt; a medium-risk profile might be made up of 30% EM equities, 30% EM hard currency debt, 30% EM local debt, and 10% EM corporate debt; while a higher risk profile could include 60% EM equities, 30% EM local debt, and 10% EM hard currency debt. These profiles can then themselves be plotted along the efficient frontier to show what levels of risk and return investors may expect of them.

### **A More Effective Approach**

The strong potential rewards from EM stocks and bonds make them highly sought after during times like the present, when developed market assets are offering comparably meager rewards. By adopting a multi-strategy approach that treats EM equity and EM debt as comparable—rather than fundamentally different—assets, it is possible to build an EM portfolio that is diversified across risk factors and the capital structure, potentially delivers durable alpha, and benefits from both bottom-up and top-down processes of active management. Investors are likely to find that this approach is more effective than treating EM equity and EM debt as fundamentally different asset classes in the same way as developed market stocks and bonds.

---

#### **Additional Disclosures**

MSCI and its affiliates and third party sources and providers (collectively, “MSCI”) makes no express or implied warranties or representations and shall have no liability whatsoever with respect to any MSCI data contained herein. The MSCI data may not be further redistributed or used as a basis for other indices or any securities or financial products. This report is not approved, reviewed, or produced by MSCI. Historical MSCI data and analysis should not be taken as an indication or guarantee of any future performance analysis, forecast or prediction. None of the MSCI data is intended to constitute investment advice or a recommendation to make (or refrain from making) any kind of investment decision and may not be relied on as such.

Information has been obtained from sources believed to be reliable but J.P. Morgan does not warrant its completeness or accuracy. The index is used with permission. The Index may not be copied, used, or distributed without J.P. Morgan’s prior written approval. Copyright © 2019, J.P. Morgan Chase & Co. All rights reserved.

T. Rowe Price focuses on delivering investment management excellence that investors can rely on—now and over the long term.

**T.RowePrice®**

#### Important Information

This material is being furnished for general informational purposes only. The material does not constitute or undertake to give advice of any nature, including fiduciary investment advice, and prospective investors are recommended to seek independent legal, financial and tax advice before making any investment decision. T. Rowe Price group of companies including T. Rowe Price Associates, Inc. and/or its affiliates receive revenue from T. Rowe Price investment products and services. **Past performance is not a reliable indicator of future performance.** The value of an investment and any income from it can go down as well as up. Investors may get back less than the amount invested.

The material does not constitute a distribution, an offer, an invitation, a personal or general recommendation or solicitation to sell or buy any securities in any jurisdiction or to conduct any particular investment activity. The material has not been reviewed by any regulatory authority in any jurisdiction.

Information and opinions presented have been obtained or derived from sources believed to be reliable and current; however, we cannot guarantee the sources' accuracy or completeness. There is no guarantee that any forecasts made will come to pass. The views contained herein are as of the date written and are subject to change without notice; these views may differ from those of other T. Rowe Price group companies and/or associates. Under no circumstances should the material, in whole or in part, be copied or redistributed without consent from T. Rowe Price.

The material is not intended for use by persons in jurisdictions which prohibit or restrict the distribution of the material and in certain countries the material is provided upon specific request. It is not intended for distribution to retail investors in any jurisdiction.

**Australia**—Issued in Australia by T. Rowe Price Australia Limited (ABN: 13 620 668 895 and AFSL: 503741), Level 50, Governor Phillip Tower, 1 Farrer Place, Suite 50B, Sydney, NSW 2000, Australia. For Wholesale Clients only.

**Brunei**—This material can only be delivered to certain specific institutional investors for informational purpose upon request only. The strategy and/or any products associated with the strategy has not been authorised for distribution in Brunei. No distribution of this material to any member of the public in Brunei is permitted.

**Canada**—Issued in Canada by T. Rowe Price (Canada), Inc. T. Rowe Price (Canada), Inc.'s investment management services are only available to Accredited Investors as defined under National Instrument 45-106. T. Rowe Price (Canada), Inc. enters into written delegation agreements with affiliates to provide investment management services.

**China**—This material is provided to specific qualified domestic institutional investor or sovereign wealth fund on a one-on-one basis. No invitation to offer, or offer for, or sale of, the shares will be made in the People's Republic of China ("PRC") (which, for such purpose, does not include the Hong Kong or Macau Special Administrative Regions or Taiwan) or by any means that would be deemed public under the laws of the PRC. The information relating to the strategy contained in this material has not been submitted to or approved by the China Securities Regulatory Commission or any other relevant governmental authority in the PRC. The strategy and/or any product associated with the strategy may only be offered or sold to investors in the PRC that are expressly authorized under the laws and regulations of the PRC to buy and sell securities denominated in a currency other than the Renminbi (or RMB), which is the official currency of the PRC. Potential investors who are resident in the PRC are responsible for obtaining the required approvals from all relevant government authorities in the PRC, including, but not limited to, the State Administration of Foreign Exchange, before purchasing the shares. This document further does not constitute any securities or investment advice to citizens of the PRC, or nationals with permanent residence in the PRC, or to any corporation, partnership, or other entity incorporated or established in the PRC.

**DIFC**—Issued in the Dubai International Financial Centre by T. Rowe Price International Ltd. This material is communicated on behalf of T. Rowe Price International Ltd. by its representative office which is regulated by the Dubai Financial Services Authority. For Professional Clients only.

**EEA ex-UK**—Unless indicated otherwise this material is issued and approved by T. Rowe Price (Luxembourg) Management S.à r.l. 35 Boulevard du Prince Henri L-1724 Luxembourg which is authorised and regulated by the Luxembourg Commission de Surveillance du Secteur Financier. For Professional Clients only.

**Hong Kong**—Issued in Hong Kong by T. Rowe Price Issued by T. Rowe Price Hong Kong Limited, 6/F, Chater House, 8 Connaught Road Central, Hong Kong. T. Rowe Price Hong Kong Limited is licensed and regulated by the Securities & Futures Commission. For Professional Investors only.

**Indonesia**—This material is intended to be used only by the designated recipient to whom T. Rowe Price delivered; it is for institutional use only. Under no circumstances should the material, in whole or in part, be copied, redistributed or shared, in any medium, without prior written consent from T. Rowe Price. No distribution of this material to members of the public in any jurisdiction is permitted.

**Korea**—This material is intended only to Qualified Professional Investors upon specific and unsolicited request and may not be reproduced in whole or in part nor can they be transmitted to any other person in the Republic of Korea.

**Malaysia**—This material can only be delivered to specific institutional investor upon specific and unsolicited request. The strategy and/or any products associated with the strategy has not been authorised for distribution in Malaysia. This material is solely for institutional use and for informational purposes only. This material does not provide investment advice or an offering to make, or an inducement or attempted inducement of any person to enter into or to offer to enter into, an agreement for or with a view to acquiring, disposing of, subscribing for or underwriting securities. Nothing in this material shall be considered a making available of, solicitation to buy, an offering for subscription or purchase or an invitation to subscribe to or purchase any securities, or any other product or service, to any person in any jurisdiction where such offer, solicitation, purchase or sale would be unlawful under the laws of Malaysia.

**New Zealand**—Issued in New Zealand by T. Rowe Price Australia Limited (ABN: 13 620 668 895 and AFSL: 503741), Level 50, Governor Phillip Tower, 1 Farrer Place, Suite 50B, Sydney, NSW 2000, Australia. No Interests are offered to the public. Accordingly, the Interests may not, directly or indirectly, be offered, sold or delivered in New Zealand, nor may any offering document or advertisement in relation to the Interests be distributed in New Zealand, other than in circumstances where there is no contravention of the Financial Markets Conduct Act 2013.

**Philippines**—THE STRATEGY AND/ OR ANY SECURITIES ASSOCIATED WITH THE STRATEGY BEING OFFERED OR SOLD HEREIN HAVE NOT BEEN REGISTERED WITH THE SECURITIES AND EXCHANGE COMMISSION UNDER THE SECURITIES REGULATION CODE. ANY FUTURE OFFER OR SALE OF THE STRATEGY AND/ OR ANY SECURITIES IS SUBJECT TO REGISTRATION REQUIREMENTS UNDER THE CODE, UNLESS SUCH OFFER OR SALE QUALIFIES AS AN EXEMPT TRANSACTION.

**Singapore**—Issued in Singapore by T. Rowe Price Singapore Private Ltd., No. 501 Orchard Rd, #10-02 Wheelock Place, Singapore 238880. T. Rowe Price Singapore Private Ltd. is licensed and regulated by the Monetary Authority of Singapore. For Institutional and Accredited Investors only.

**South Africa**—T. Rowe Price International Ltd ("TRPIL") is an authorised financial services provider under the Financial Advisory and Intermediary Services Act, 2002 (FSP Licence Number 31935), authorised to provide "intermediary services" to South African investors.

**Switzerland**—Issued in Switzerland by T. Rowe Price (Switzerland) GmbH, Talstrasse 65, 6th Floor, 8001 Zurich, Switzerland. For Qualified Investors only.

**Taiwan**—This does not provide investment advice or recommendations. Nothing in this material shall be considered a solicitation to buy, or an offer to sell, a security, or any other product or service, to any person in the Republic of China.

**Thailand**—This material has not been and will not be filed with or approved by the Securities Exchange Commission of Thailand or any other regulatory authority in Thailand. The material is provided solely to "institutional investors" as defined under relevant Thai laws and regulations. No distribution of this material to any member of the public in Thailand is permitted. Nothing in this material shall be considered a provision of service, or a solicitation to buy, or an offer to sell, a security, or any other product or service, to any person where such provision, offer, solicitation, purchase or sale would be unlawful under relevant Thai laws and regulations.

**UK**—This material is issued and approved by T. Rowe Price International Ltd, 60 Queen Victoria Street, London, EC4N 4TZ which is authorised and regulated by the UK Financial Conduct Authority. For Professional Clients only.

**USA**—Issued in the USA by T. Rowe Price Associates, Inc., 100 East Pratt Street, Baltimore, MD, 21202, which is regulated by the U.S. Securities and Exchange Commission. For Institutional Investors only.

© 2019 T. Rowe Price. All rights reserved. T. ROWE PRICE, INVEST WITH CONFIDENCE, and the Bighorn Sheep design are, collectively and/or apart, trademarks of T. Rowe Price Group, Inc.