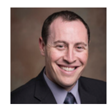
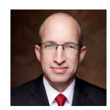
Questions Investors Should Consider for an Optimal EM Allocation

A Q&A with our multi-asset solutions team.

October 2019



Justin Harvey
Head of Analysis, Multi-Asset Solutions



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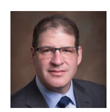


Lowell H. Yura
Head of Multi-Asset Solutions, North America

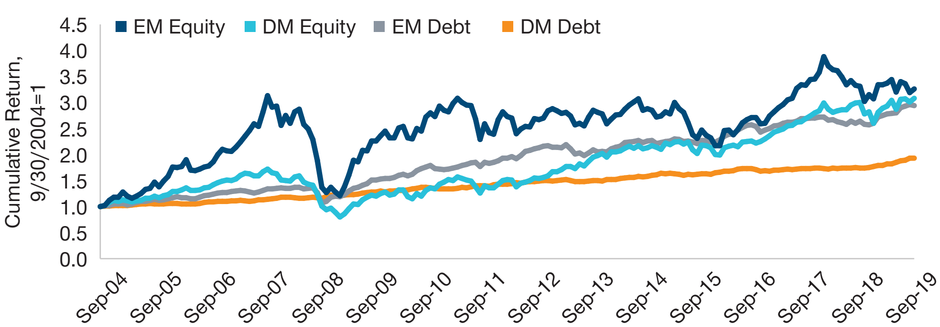
KEY INSIGHTS

- We believe that the most successful long-term investors will recognize that each emerging markets (EM) asset class should play a defined role in their portfolio.
- The EM opportunity set is diverse and growing and offers different opportunities depending on investors' objectives and time horizons.
- Historical returns, volatility levels, and correlations can help investors decide which asset classes are best suited to their goals and risk tolerance levels.

There are many arguments in favor of investing in emerging markets (EM). The diverse opportunity set offers attractive yields, and many areas remain undervalued. However, it's crucial to understand that not all asset classes within the EM universe are the same. Different areas and asset classes within EM offer different potential benefits, risks, and characteristics. Below is a series of questions that investors should address to help guide their EM investments.

(Fig. 1) EM Equity and Debt Offer Attractive Track Records

Equity and hard currency debt returns in developed markets (DM) and EM
As of September 30, 2019



Past performance is not a reliable indicator of future performance.
EM Equity: MSCI Emerging Markets Equity Index; DM Equity: MSCI World Index; EM Debt: J.P. Morgan EMBI Global Diversified Index; DM Debt: Bloomberg Barclays Global Aggregate Bond Index.
Sources: MSCI (See Additional Disclosures), J.P. Morgan (See Additional Disclosures), and Bloomberg Index Services Limited (See Additional Disclosures).

What Role Should EM Play in an Investor's Portfolio (e.g., Income, Growth, Diversification)?

We believe the most successful investors will calibrate their expectations for each asset class based on the defined role it plays in their portfolios. Therefore, when deciding where to invest in the EM opportunity set, investors should consider what goal they are trying to achieve and which asset classes are best suited to reaching that goal.

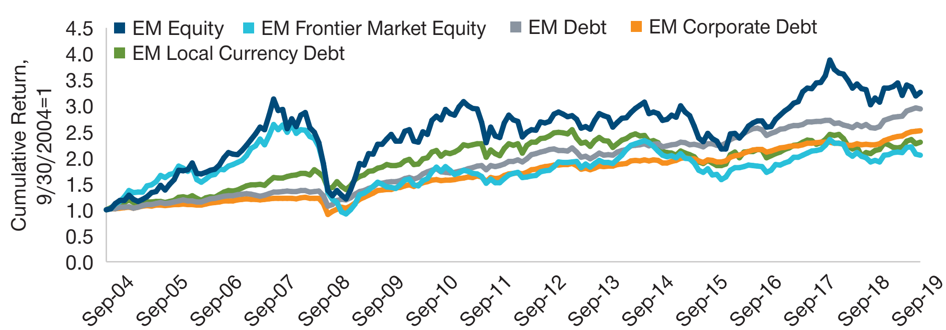
Some investors may want to maximize their long-term returns, others will prioritize stable income generation, and some may primarily invest in EM to add diversity to their portfolios. Looking at the track records, behaviors, and different characteristics of the main EM asset classes can help investors determine what each asset class can do to help achieve their goals.

- Growth-seeking investors can find opportunities to help achieve their goals in all segments of the EM universe. Both equity and fixed income markets possess strong growth potential, highlighted by EM hard currency debt and EM equity's outperformance against their developed market (DM) counterparts over the past 15 years. Investment in EM, overall, has grown significantly in the past 15 years as many EM economies matured. As a result, sovereign spreads have come down and were one factor behind the climb of equity prices.
- Many segments of EM offer strong income potential relative to their developed market counterparts. In a world of low, or even negative, developed market bond yields, the higher yields in EM debt offer investors opportunities to locate attractive income, some at investment-grade creditworthiness. Hard currency sovereign and corporate bonds reduce the risk that returns will be impacted by swings in EM currency markets.
- For diversification needs, investors should remember that as risk assets, both EM equity and EM debt will not necessarily provide diversification with respect to global equity markets. However, an active approach seeks to uncover specific EM opportunities in countries or companies undertaking positive reforms that could potentially generate alpha in different market environments, and this alpha may be lowly correlated with general equity

(Fig. 2) Positive Returns Across EM

Performances by EM asset class over past 15 years

As of September 30, 2019



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Sources: MSCI (See Additional Disclosures) and J.P. Morgan (See Additional Disclosures).

Growth-seeking investors can find opportunities to help achieve their goals in all segments of the EM universe.

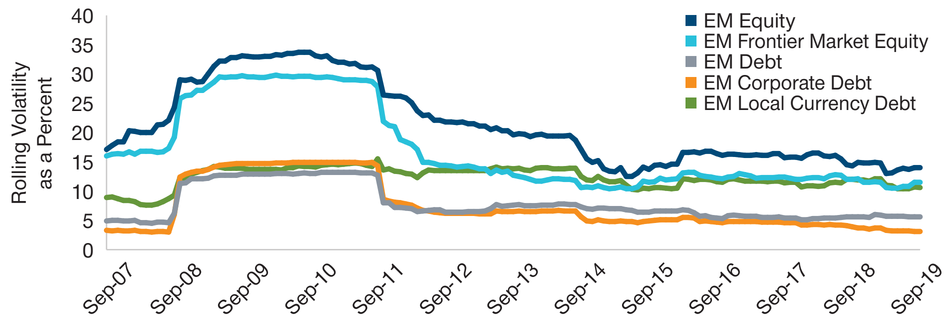
— **Lowell H. Yura**

Head of Multi-Asset Solutions, North America

(Fig. 3) EM Volatility Has Declined

Rolling volatility by EM asset class

As of September 30, 2019



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Volatility is measured by standard deviation and is calculated over rolling 3-year periods.

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Sources: MSCI (See Additional Disclosures) and J.P. Morgan (See Additional Disclosures). Data analysis by T. Rowe Price.

market movements. EM local currency bonds could allow investors to invest in countries at different points of the monetary cycle than their home country. This opens up opportunities to diversify away from U.S. Treasuries, German bunds, or other core developed government bond markets.

What Is Your Time Horizon?

The time horizon of investors can impact which asset classes within EM are best suited to their goals. Investors should consider differences in historical returns and volatility levels to help determine an optimal allocation for their planned investment period.

- **3–5 Years**—Although, overall, EM risk levels have come down in recent years, drawdowns can disrupt returns without sufficient time for losses to be recouped as markets recover. Therefore, time horizons under three years may be too risky for significant allocation to EM. However, investors can reduce the risks in the three- to five-year bracket by focusing on asset classes with lower historical volatility. The relatively low historical drawdowns in the EM sovereign and corporate debt asset classes make these attractive options for investors with shorter time horizons. Hard currency EM debt also allows investors to sidestep the swings in foreign exchange markets.

- **5–10 Years**—A medium-term investment horizon allows for more recovery time, adding to the options for investors who want exposure to asset classes that might be more prone to short-term price swings but can deliver strong performance over the full market cycle. For example, EM local currency bonds along with the EM hard currency and corporate debt could play an important diversifying role. EM equity's potential for outperforming its developed market counterpart also makes it a viable option, particularly for time horizons approaching 10 years.

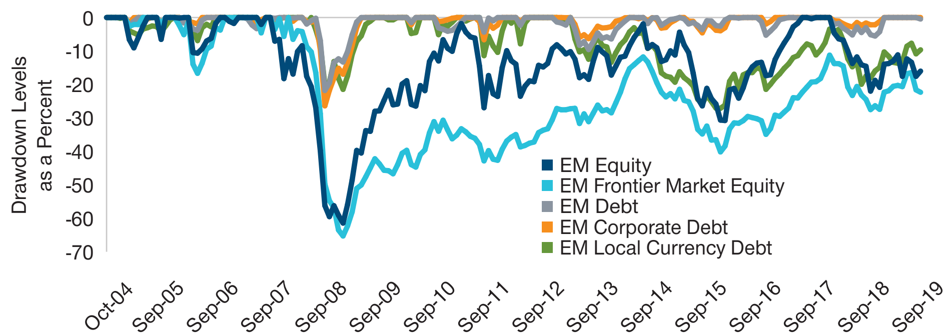
- **With a longer-term horizon**—The full breadth of EM asset classes comes into view due to the ample time for recovery periods should drawdowns weigh on returns. Investors can seek to add stability by maintaining

....astute investors might think about what historical performances reveal about how an asset class responds to periods of stress, how quickly it can rebound following sell-offs, or how correlated it is to other sectors.

— Justin Harvey
Head of Analysis, Multi-Asset Solutions

(Fig. 4) Differences in Performance and Recovery

Drawdowns by asset class over time
As of September 30, 2019



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Sources: MSCI (See Additional Disclosures) and J.P. Morgan (See Additional Disclosures). Data analysis by T. Rowe Price.

exposure to EM hard currency sovereign and corporate bond assets as well as diversity through EM local currency debt allocations. Additionally, high yield EM asset or frontier markets offer an expanded investment opportunity set and idiosyncratic investment opportunities from a bottom-up perspective. While these sectors may hold the most risk, the longer time horizon allows for recovery and potential outperformance as specific countries or companies reform and grow.

What Correlations Should Be Considered?

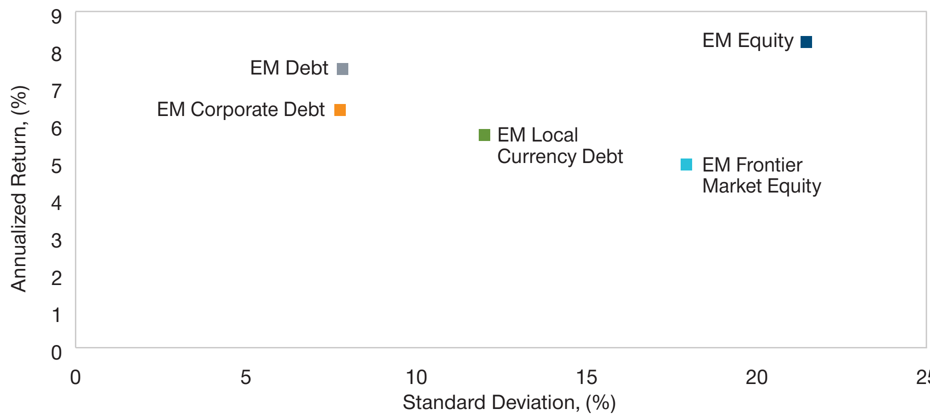
EM investments are also risk assets, meaning that both EM equity and fixed income will typically show positive correlation to global equity markets as well as global high yield bond markets. While it is true that EM is more diverse and less risky than it was 10 or 20 years ago, investors should be prepared for drawdowns and volatility during periods of wider risk aversion that might also impact global equities. Investors should consider this correlation when deciding how their EM allocation fits into their overall portfolio.

Investors should also think about how EM debt and equity markets are correlated to core bond rates. Some elements of EM, such as EM equity, may show a negative correlation. Generally speaking, a rally in core DM bonds may suggest global investors are more risk averse and are moving away from EM risk assets to the perceived safety of DM government assets. Conversely, a positive global backdrop may see investors shift to riskier and higher-yielding EM assets, which would boost EM asset prices while core DM bonds sell off. Investors seeking diversification should consider these interactions when designing their portfolios. Additionally, local currency EM bonds could offer diversification opportunities as returns in individual markets are driven by interest rates, inflation, and fiscal and central bank policies in their respective countries.

> EM is a growing and evolving asset class. This is one of the reasons why it can make an exciting opportunity.
>
> — **Yoram Lustig**
> *Head of Multi-Asset Solutions, EMEA*

(Fig. 5) Balancing Return Potential With Volatility

Long-term risk/return by asset class
September 30, 2004 to September 30, 2019



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Sources: MSCI (See Additional Disclosures) and J.P. Morgan (See Additional Disclosures). Data analysis by T. Rowe Price.

What Is the Best Way to Implement an EM Allocation Strategy?

Once investors have considered their investment objectives and time horizon, they will likely have an idea of which EM asset classes are best suited to their needs. Next, it makes sense for investors to think about how to implement and manage their EM investments.

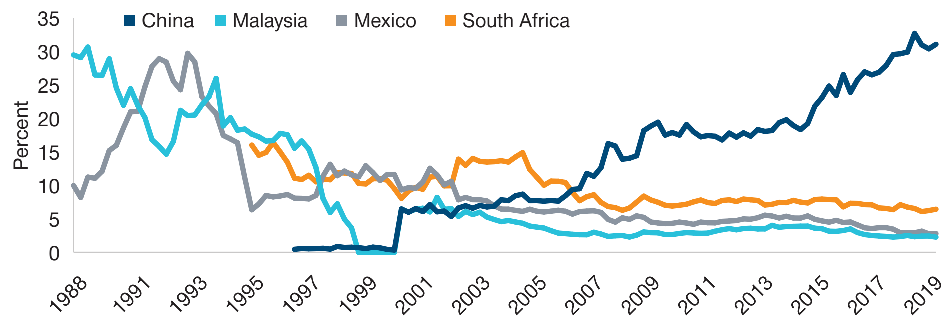
First of all, investors should decide on the size of their EM allocation. In addition to risk tolerance level, one factor impacting how big an EM allocation should be is whether it is an offshoot of an investor's equity or fixed income portfolio or a part of their growth assets. We regard all EM asset classes as growth assets. The track records of EM equity, debt, and local currency assets show that they can deliver strong returns on capital over the longer term. For this reason, all segments of EM form a potential fit with an investor's overall growth allocation. Due to EM's track record of outperforming developed markets over the long term, we believe that it can form a significant portion of investors' portfolios as both EM equity and debt have shown they can outperform developed markets over the long term. They are also forming increasingly large portions of global indices.

Investors can also think about whether a strategic or tactical allocation is the best approach. Strategic allocation takes a long-term view and should be based on forward-looking expectations of the behavior of asset classes alongside investors' objectives and risk parameters. A strategic allocation study provides a useful first step in deciding the size of an EM allocation. Tactical asset allocation allows investors to shift their investments across different asset classes, depending on their views on market direction. While tactical investors may experience more swings in performance, investors could add potential alpha by overweighting or underweighting certain market segments or reducing risk exposure by

(Fig. 6) The EM Opportunity Set Has Shifted Dramatically

Country allocations within the MSCI Emerging Markets Index

As of March 31, 2019



Sources: Credit Suisse (see Additional Disclosures), FactSet (see Additional Disclosures), and MSCI (see Additional Disclosures).

moving away during times of expected stress. A tactical EM component as part of their larger strategic investment portfolio may help investors take advantage of short- or medium-term directional market views.

Management style is important for all types of portfolio mixes. A disciplined manager may improve long-term returns through superior security selection as well as shifting exposures to different market sectors and regions to take advantage of changing conditions or market inefficiencies.

Another important consideration is determining the most appropriate benchmark, or measure of success, for an EM allocation. Investors could consider the following:

- Measuring performance against a relevant benchmark for that specific asset class can provide a bottom-up perspective. This benchmark-aware evaluation can indicate whether a manager's security selection and active allocation made a positive or negative impact.
- Measuring performance against a composite benchmark helps provide a top-down look at the allocation's success. Because EM asset classes experience varying degrees of volatility, we believe it is important to compare returns across different time horizons and for investors to keep in mind their own investment objectives.
- Measuring against predefined return and risk targets may be appropriate for absolute return strategies or to check whether the portfolio meets the desired outcomes. However, this method would not capture the wider market context, which is important to gain a proper understanding of how a portfolio performed. For example, an allocation to EM hard currency debt may fall short of absolute return targets for a set time period but still outperform the wider market over the period. Therefore, this allocation could contribute to helping a portfolio achieve its long-term return goals by mitigating the losses during a specific period.

Are Expectations Based on Historical EM Return Experiences Useful, or Are We in a Different Regime?

Historical returns, volatility, and drawdowns can provide useful guideposts for investors to compare how asset classes behaved in different market environments over time. Rather than expecting return levels to be replicated, astute investors might think about what historical performances reveal about how an asset class responds to periods of stress, how quickly it can rebound following sell-offs, or how correlated it is to other sectors. While these trends often change in the future, they may provide a meaningful indicator to an asset class's characteristics. It is important to look at track records over a relatively long time period that might incorporate multiple market regimes.

That said, EM is a growing and evolving asset class. This is one of the reasons why it can make an exciting opportunity. However, investors should note that the growth and development of EM means that historical trends, returns, and correlations may change going forward. The current market is unique due to a number of factors, including the high amount of ultralow and negative yielding debt in developed markets alongside persistently low inflation levels. The political sphere in both emerging and developed markets also contains a high degree of uncertainty. While we still believe many traditional characteristics of EM, such as strong growth potential, can continue, the future may be fundamentally different than the past.

Furthermore, the heterogenous nature of EM means that it cannot be thought of as a single investment opportunity. Investors who go deeper can uncover idiosyncratic names and sectors that may go against wider market trends. Therefore, knowledge gained from historical EM performance should be combined with a forwarding-looking market outlook and an investor's own priorities.

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