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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.

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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

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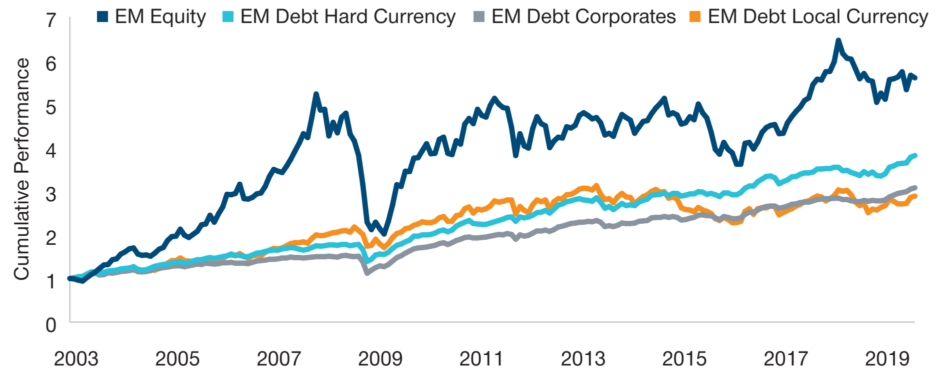
(Fig. 1) Differentiated Exposure

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

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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.

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