WHY ACTIVE MANAGEMENT IS IMPORTANT IN EMERGING MARKETS LOCAL CURRENCY BONDS

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Active management may offer significant advantages over passive management for bond investors. In emerging markets debt, and particularly in local currency bonds, the case is even more compelling.

Replicating a passive index can be difficult for any fixed income sector, but even more so in niche markets such as emerging markets debt. With fewer market makers, fragmented ownership, and reduced global sovereign issuance, liquidity has become a more important consideration in debt markets, particularly in the historically less-liquid emerging markets. In this space, efficiently executing transactions—particularly within a passive vehicle that provides intraday liquidity—can be challenging and adds considerable costs to rebalancing activities.

Moreover, active management offers investors a much broader opportunity set than passive portfolios. For example, our Emerging Markets Local Currency Bond Strategy has the flexibility to tactically invest in a wide universe of emerging markets debt, including hard currency bonds, quasi-sovereign bonds, supranational bonds, local corporate debt, local inflation-linked bonds, and frontier market issues. By contrast, portfolios that passively track capitalization-weighted indices tend to be highly concentrated, especially in the more heavily indebted countries.

Active management can also exploit the different interest rate cycles between countries to add value. Economies where interest rates are declining or are about to decline—often those that are undergoing a disinflationary trend—will typically offer greater opportunities for capital appreciation than those where interest rates are stable or rising (see Figure 1). Passive management, however, is less likely to capture these differences in interest rate cycles.

Figure 1: Divergence Between Countries Creates Opportunity
Illustrative Interest Rate Cycle, as of March 31, 2017

The columns showing cuts versus hikes are the actual cuts and hikes that have happened across developing (gray) and developed (blue) countries worldwide. Euro area includes those countries where the euro is legal tender.
Sources: CRB Rates; data analysis by T. Rowe Price.
Another benefit of active investment in emerging markets local currency debt is the potential reduction in currency risk. In recent years, coupons have generated most of the returns from emerging markets local currency bonds, while currency has been the riskiest element. In fact, over the decade to December 2016, foreign exchange (FX) had a negative impact on the performance of the J.P. Morgan GBI-EM Index (see Figure 2).

**Figure 2: J.P. Morgan GBI-EM FX Impact Only Performance in USD**
Weekly Cumulative Performance in USD (Base 100 = December 2006), as of December 31, 2016

Past performance cannot guarantee future results.
Source: J.P. Morgan Chase & Co.

Actively managing currencies can reduce volatility, keeping a portfolio from large downdrafts. For example, our decision to go underweight the Turkish lira in the last three months of 2016 was positive as the currency depreciated steeply following concerns over the changing political and economic environment in Turkey. Passively managed portfolios, by contrast, may not necessarily shield investors during sharp currency sell-offs, exposing them to potentially greater currency volatility and lower performance.

In addition to allowing a manager to limit the impact of currency risk, active selection can also facilitate the search for currency alpha, which may boost a portfolio’s risk/return trade-off. Our Emerging Markets Local Currency Bond Strategy consistently generated a high portfolio return contribution from active foreign exchange positioning and produced a high rolling three-year foreign exchange information ratio (see Figure 3).

Furthermore, investors in passive emerging markets local currency bond vehicles would have lost out, owing to the stronger U.S. dollar in recent years. Relative value currency trades can help mitigate broad emerging market currency depreciation, again highlighting the importance of actively managing emerging market currency exposure.

**Figure 3: High Portfolio Return Contribution From FX**
As of March 31, 2017

Past performance cannot guarantee future results.
Source: T. Rowe Price. The return contribution and information ratio refer to representative strategy.