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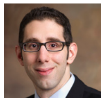
EMERGING MARKETS CORPORATE BONDS: THE ACTIVE OPPORTUNITY

July 2020



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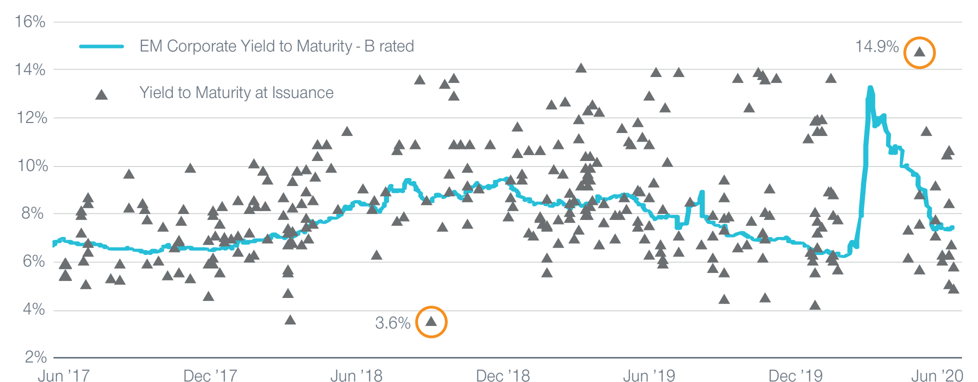
At a time when passive investing continues to gain market share, emerging market (EM) corporate bonds are an asset class that remains inefficient and under-researched enough to reward active security selection, potentially allowing active managers to add value consistently over time.

One source of active opportunity is lack of dedicated sponsorship. Of the roughly US$2.4 trillion EM corporate debt market, only about 5% is owned by dedicated investors—entities that specialize in this asset class and are benchmarked to the J. P. Morgan CEMBI indices. The rest is held by retail investors, crossover investors (e.g. investment-grade managers dipping into high-yield names to pick up additional yield) and other non-specialists. Non-specialist investors tend to be slower to identify and exploit mis-pricings or dislocations in the market. They can also be more sensitive and likely to sell in response to negative news flow, which may cause them to miss out on longer-term fundamental improvements.

A second source of opportunity is wide dispersion of valuations. For example: the marks in the chart below show the yields to maturity (YTM) at which new single B rated issues have come to market since 2017. The line in the chart shows the average YTM on the B rated portion of the EM corporate index.

Display 1 Wide Dispersion of Valuations

Yields of B-Rated Emerging Market Corporate Bonds



As of 30 June 2020
The chart reflects B-rated bonds issued from emerging markets corporates in USD terms. It is a comprehensive universe including issues in and off the J.P. Morgan CEMBI Broad Diversified Index.
Sources: J.P. Morgan Chase & Co., Bond Radar. Data analysis by T. Rowe Price.

THE EMERGING
EDGE

> Emerging market corporate bonds are an asset class that remains inefficient and under-researched enough to reward active security selection, potentially allowing active managers to add value consistently over time.

The yields have been widely dispersed, ranging from less than 4% to almost 15%, for a single rating category. This implies that being able to differentiate between good and bad credits is crucial to success in this asset class, and that managers need enough research resources to do so.

The third potential source of active advantage is the research demands of the asset class. More than 1,700 new issuers have come to the EM corporate bond market since 2005—an average of around 70 new names a year for the high-yield segment alone. New issues often come up at short notice. Analysts typically have an underwriting period of three to five days to assess the industry, the management team, perhaps even a new country, and build an analytical model.

We believe one of our credit analysts' advantages is being able to tap into our firm's EM equity resources. For example, most EM companies issue shares well before they enter the bond markets, so although a company may be a new bond issuer, our EM equity team may have been covering it for decades.

Our EM credit analysts also sometimes draw on the expertise of our developed-market industry specialists, looking for parallels that can be applied in EM, identifying potential success factors or warning signals.

Having these research resources enables us to be highly selective—we only participate in 10% to 15% of new issues—and to have high conviction in the names we do decide to buy.

The EM corporate debt market has been particularly inefficient lately in light of the COVID-19 pandemic and the global economic downturn. Asset price dispersion today remains elevated, and investors continue to be rewarded for providing liquidity, particularly for high yield issuers. The selloff earlier this year punished many issuers indiscriminately and irrespective of quality.

Part of the recovery since has been a beta-driven rally spurred by massive global liquidity support. However, as stimulus wanes and valuations become more normalized, excess returns in the asset class are likely to be driven by careful issuer selection and alpha.

As always, our process is centered around bottom-up, fundamental research and effective security selection. This approach will become increasingly important as the market environment becomes less beta-driven and fundamentals come back to the fore.

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