BARINGS VIEWPOINTS

September 2018

# HOW DIVERSIFIED IS YOUR EMERGING MARKETS DEBT STRATEGY?

THERE MAY BE SIGNIFICANT BENEFITS TO USING A BLENDED APPROACH TO THIS ASSET CLASS

## A diverse opportunity set

Emerging markets debt (EMD) is a relatively young asset class, but one that has grown by leaps and bounds over the past 25 years or so. To a large degree, that growth has been fueled by investors' growing awareness of EMD's attractive risk-return profile and historically low correlation to more traditional asset classes.

Today, the global EMD market is valued at over $20 trillion.[1] To put that number in perspective, consider that it's within striking distance of the total market capitalization of the S&P 500 Index (approximately $24 trillion).[2] By this or any other measure, EMD represents a very large investment universe. That much is clear.

What is less clear to many investors is just how diverse the opportunities across the EMD spectrum are. The asset class includes bonds rated from high yield to investment grade, issued in dozens of currencies by both governments and corporations. In addition, it encompasses three distinct sub-asset classes—EM local debt, EM sovereign hard currency and EM corporate debt—each with its own investment characteristics and drivers of performance.

## Where to begin?

Faced with such a vast universe, many investors do not know where to begin. For most, it is simply not practical (or even advisable) to try to assemble a diversified portfolio of EMD assets on their own. That is precisely why investors often turn to mutual funds and other professionally managed portfolios. However, to help achieve optimal diversification across this asset class, multiple funds may be required, which can be cumbersome and costly.

In many cases, we believe the best way for investors to harness the EMD opportunity set is through an actively managed, blended EMD strategy—one that is broadly diversified not only across emerging countries and sectors, but also across EMD sub-asset classes and individual credits within each sub-asset class.

## The benefits of blending

For investors seeking intelligent EMD exposure, we believe the benefits of a blended investment approach are quite compelling.

A blended strategy has the flexibility to invest across the entire EMD spectrum, providing enhanced portfolio diversification and access to the full range of opportunities. As noted, each sub-asset class (as well as each credit) has its own unique attributes, with risk and return driven by common or more idiosyncratic factors. Having a skilled and well-resourced active manager who can tactically execute investments around these nuances can add considerable value for investors.

> *"One overarching benefit of a blended approach is that investors are able to 'outsource' tactical investment decisions into the hands of an active manager with expertise across the emerging markets debt spectrum."*

1. Source: IMF. As of September 2017.
2. Source: Siblis Research. As of July 2018.

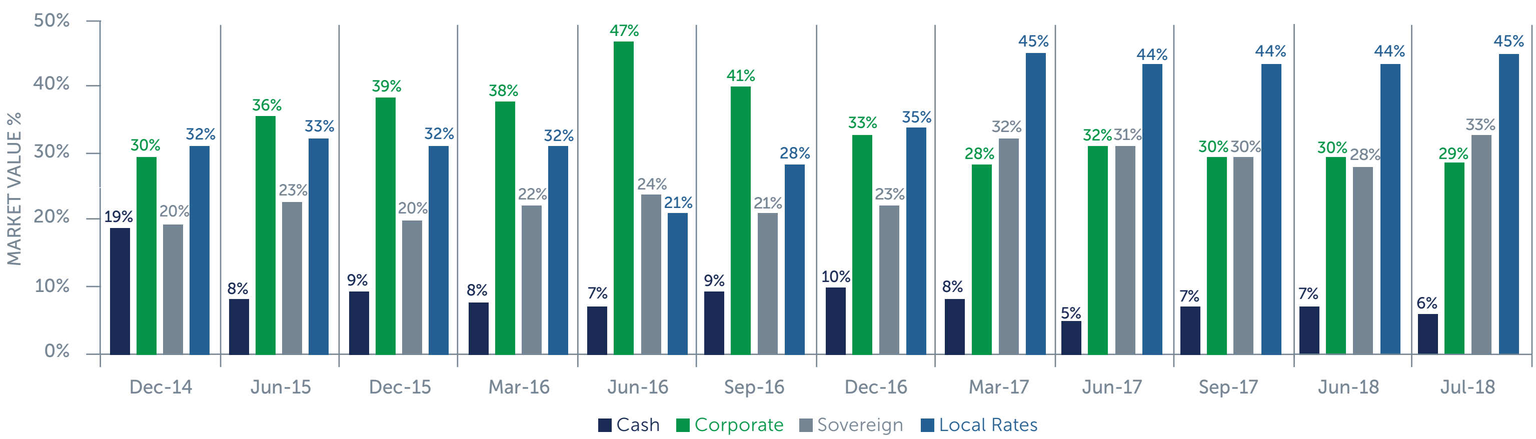
One overarching benefit of a blended approach is that investors are able to 'outsource' tactical investment decisions into the hands of an active manager with expertise across the emerging markets debt spectrum.

For instance, rising interest rates in developed markets may impact EM sovereign hard currency debt more than local currency bonds. By understanding that EM currencies and bond prices display greater sensitivity to monetary conditions and the economic cycle in home markets, managers can invest in positions that are more insulated from developed market rate increases.

Similarly, the impact of certain factors on EM sovereign debt tends to vary significantly by issuer. Net importers of oil, for instance, may benefit from lower oil prices, while exporters will likely experience more negative repercussions. The reaction in EM currencies and corporate bonds is also likely to be different.

For these reasons and others, the different EMD sub-asset classes, economies and credits can either outperform or underperform across changing market environments. This creates opportunities for active, nimble managers to invest where their conviction is greatest and to be tactical in response to where relative value appears most promising at any given time.

FIGURE 1: EVOLUTION OF NOTIONAL WEIGHTINGS IN BARINGS' EMD BLENDED STRATEGY




SOURCE: *BARINGS. AS OF JULY 31, 2018*

## The Barings approach

At Barings, our approach is to construct a portfolio that is built on our best investment ideas, leveraging the sub-asset class research and tools implemented across our EMD strategies. Specifically, our arsenal includes distinct fundamental and quantitative investment processes for corporate, sovereign, local rates and currencies.

We combine top-down asset allocation driven by macroeconomic forecasts with bottom-up security selection as the basis of our investment process. We believe this powerful combination improves our ability to identify and exploit inefficiencies across and within individual EMD sub-asset classes as they arise. Importantly, our strategy, which seeks total return, is not subject to the constraints of a benchmark. We are unconstrained in an effort to deliver maximum total return, with no benchmark to hinder us.

> *"We are unconstrained in an effort to deliver maximum total return, with no benchmark to hinder us."*

Another key strength of our blended strategy is that we are able to draw upon the in-depth research and analytical heft of each of our separate research and investment processes:

- For **hard currency sovereign debt**, we undertake in-depth macroeconomic analysis, while also considering country-specific issues, such as political risk and policies in both emerging and developed countries. We then combine our country analysis with peer group analysis and cross-country quantitative modelling to arrive at high-conviction investment ideas.

- On the **local debt** side, we split the analysis of interest rates and currencies, as we believe the economic cycle determines rate levels and that economic competitiveness defines currency positions. For rates, we use a highly sophisticated model similar to those used by central banks. Model outputs, which act as a guide to how central banks might act, are supplemented by our balance of payments analysis and central bank experience. (See EM Local Debt: Focused on Fundamentals for more information.)

- On **currencies**, our models measure export penetration and real effective exchange rates. By combining these outputs with our balance of payments analysis, we can effectively compare both emerging markets and developed markets currencies to gauge economic competitiveness and determine which currencies are undervalued or overvalued.

- For **corporate credit**, a disciplined, bottom-up approach to credit selection is critical to our investment process, particularly given the idiosyncratic drivers at play for individual credits. For instance, even if we have a negative view on a certain country or sector, we may still see opportunities there at the corporate issuer level.

We believe our ability to both look across the EM debt universe as a whole and to drill down at the sub-asset class level allows us to better pinpoint and capitalize on attractive investment opportunities, while also helping us avoid unwanted credit risks and excessive volatility.

**BARINGS' EMERGING MARKETS DEBT TEAM**

*consists of*

**19**

**INVESTMENT PROFESSIONALS**

**7** **PORTFOLIO MANAGERS** *with an average of* **20** YEARS OF EXPERIENCE

**10** **ANALYSTS** *with an average of* **12** YEARS OF EXPERIENCE

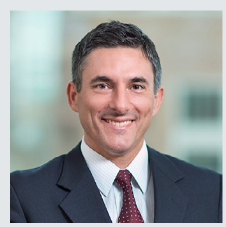
*that cover*

**85+** COUNTRIES

*and more than*

**1,100+** CREDITS

SOURCE: *BARINGS. AS OF JUNE 30, 2018.*



**DR. RICARDO ADROGUÉ**
HEAD OF EMERGING MARKETS

Dr. Ricardo Adrogué is Head of Barings' Emerging Markets Debt Group, lead portfolio manager for the Emerging Markets Local Debt strategy, and co-portfolio manager for the Emerging Markets Sovereign Hard Currency Debt and Blended Total Return Debt strategies. Having worked in the industry since 1992, his experience includes portfolio management, economic strategy and academia. Ricardo holds a B.A. in Economics from the Universidad Católica Argentina, along with an M.A. in Economics and a Ph.D. from the University of California, Los Angeles.

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