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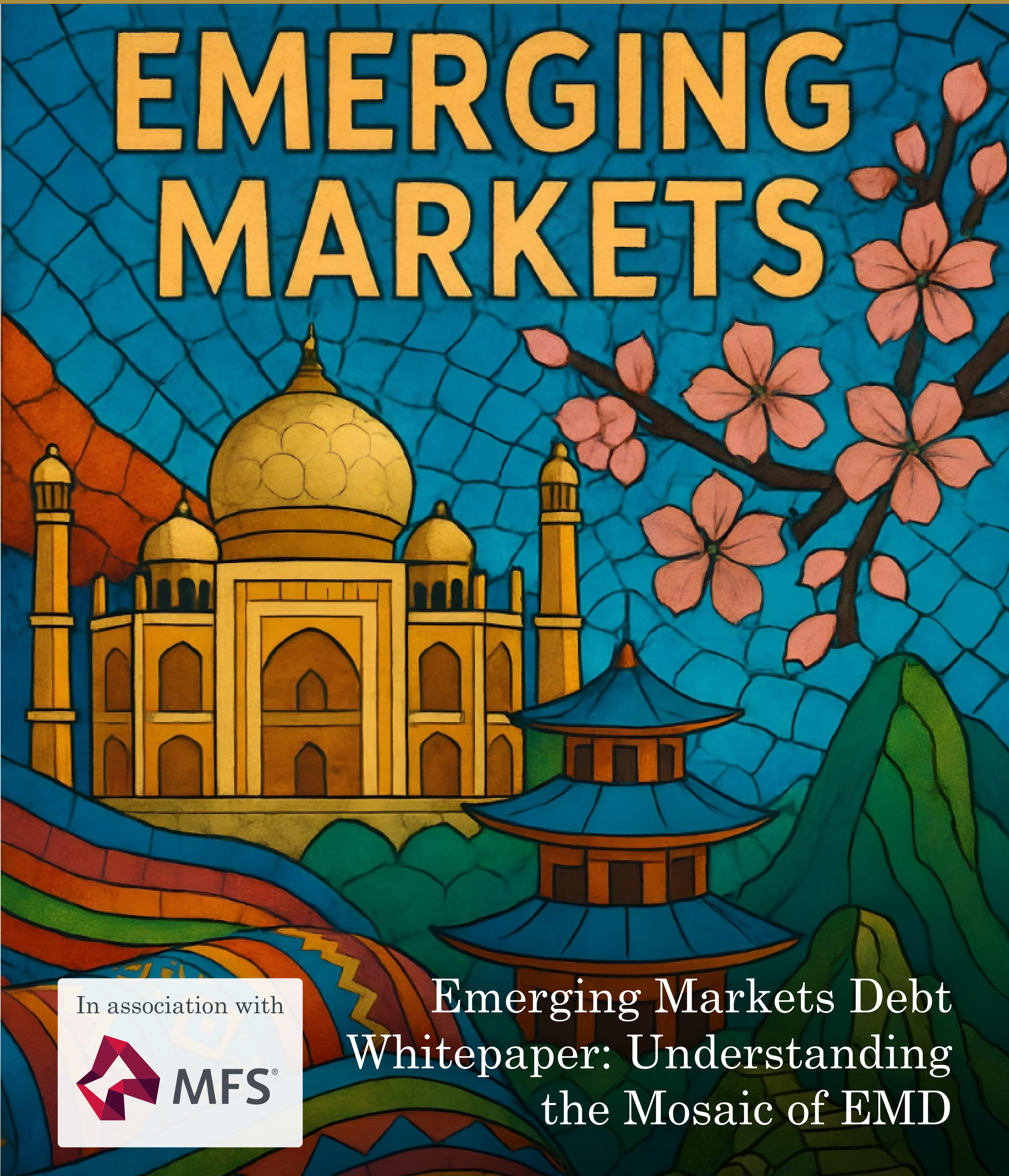

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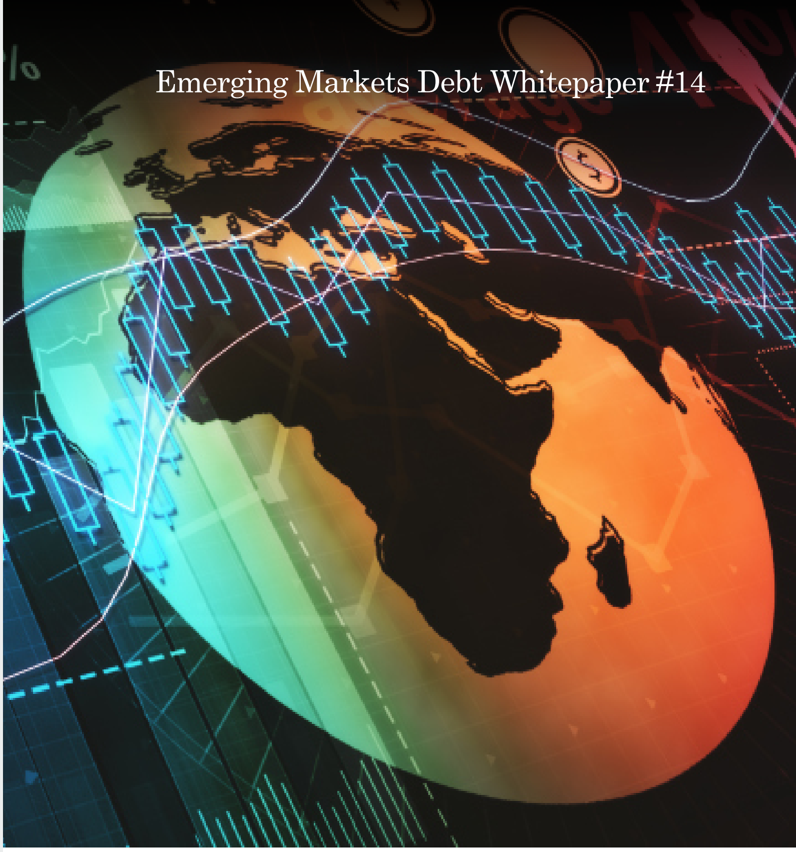
Emerging Markets Debt Whitepaper: Understanding the Mosaic of EMD



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Thank you to our sponsor for this edition of the Emerging Markets Debt Roundtable.

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Understanding the Mosaic of EMD

Emerging Markets Debt (EMD) has delivered mixed returns to investors down the years. Perpetual optimism that developing countries will generate better returns on capital than mature, industrialised nations has not always been borne out by reality. While some EMD issuers have provided excellent risk-adjusted returns, others have been blown off course by reckless fiscal policies. Certain factors have been beyond issuers' control, notably the enduring strength of the US dollar and the deep damage caused by coping with the COVID pandemic. Nine EM sovereign issuers have been involved in debt restructuring in recent years. On the other hand, EM corporate debt has been the best performing category in public fixed income markets over ten years.

Evaluating this mosaic of opportunities and risks was the task of a cio investment club roundtable in March 2025. The first question was whether the year ahead was a risk-on environment for institutional investors. Half the panel voted 'yes' and half voted 'no' – an early indication of the uncertainty in global markets these days.

All panellists, however, recognised the relative attractiveness of EMD within a fixed income portfolio, scoring it at least 7 out of 10. Among the 'risk-on' trio, Alastair Whitfield, Head of Investments & Treasury Management at IQUW, a property and speciality insurer and reinsurer, scored EMD 8/10 over the next year.

"We have been conservative in our overall asset allocation in the past but are now looking across the full breadth of fixed income so long as it remains within our overall investment risk appetite," he said. "We have been thinking about EMD Hard Currency (HC) long-only or unconstrained," he said. This formed part of a recent manager search assisted by bfinance, which is now complete.

Like IQUW, the £3bn Lloyd's Central Fund is expanding its fixed income portfolio choices in pursuit of diversification. Anthony David, rates and fixed income manager at Lloyd's Central fund, said that

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over the last 12 months, its strategy has been to broaden into other asset classes and instruments. "We are still constrained by insurance regulations, which favour govvies and high-quality Investment Grade (IG)," he said. "But we also have allocations to High Yield (HY) and EMD."

Most of the Lloyd's Central Fund is internally managed. External managers are used for Multi-Asset Credit (MAC) which includes EMD and HY. David and colleagues have the flexibility to go opportunistically into single EMD names, as well as allocating to EMD at an asset class level.

For IQUW, Whitfield said there was some leeway for external managers to take active duration positioning although he said the managers tended to prefer making active bets via security selection and sector rotation.

Katrina Uzun, institutional portfolio manager at MFS, noted that most of the current demand for EMD is coming from crossover investors without an EMD benchmark. She said this explains why spreads are so tight, with IG-rated and even lower credit quality like BB-issuance three or four times oversubscribed. Meanwhile, in contrast, dedicated EMD products have been experiencing outflows, notably from retail mutual funds in the U.S.

Pension Corporation's business is taking on the management of pension liabilities from occupational pension scheme sponsors. Hartej Singh, head of public credit at Pension Corporation, said that he was generally more positive on sovereign valuations than high-quality corporates, across EM as well as DM. His reason was that corporate spreads had compressed as a result of buying pressure from the managers of mature Defined Benefit pension funds. He argued that these managers have been focussing on Investment Grade (IG) as the sweet spot available to them in terms of meeting creditworthiness and yield. He added that sub-IG, in spite of recent regulatory changes regarding the matching adjustment for UK insurers, still remained unattractive.

Uzun pointed out that EM corporate debt issuance had grown so much over the last ten years that the market was now roughly the same size as the EM sovereign market, ie USD1.1 trn. In relation to Singh's last point, she said that EM corporate debt was IG on average. Comparing corporate debt in EM and DM, Uzun said that leverage per each credit quality bucket was a lot lower in the former. "Even when the credit rating is the same, the spread per turn of leverage in each credit quality category is much more attractive in EM," she said.

The Narrower Buying Base

Moreover, she claimed that plotting an Efficient Frontier for a portfolio of EM corporates and EM sovereigns over the past decade would indicate that the most optimal allocation would be 100% to EM corporate debt. This is because, over the last ten years, this asset class has delivered higher returns for a lower level of risk. However, the challenge lies in the fact that EM corporates lack a broad buyer base. JP Morgan, which provides the most popular EM bond indices, estimates this base to be roughly around USD200bn, which is significantly less than the total market size of USD1.1trn.

So who accounts for the rest of the universe? Uzun told the cio investment club roundtable that much comes from crossover investors, such as Multi-Asset Credit strategies (MACs). The danger is that in risk-off environments, these investors tend to go back to benchmark and liquidity dries up. "It is then an asset class without a home," she said.

Asked how MFS's EM team addresses this risk, Uzun explained that it takes maximum exposure of 25-40 basis points in any one off-benchmark HC corporate issuer. That makes exits easier. MFS also plays across the curve for the same reason, controlling for duration by use of Treasury futures.

For colour, she noted that insurance companies all around the world were buying in this asset class, often held to maturity.

Rickey Thevakarrunai, manager researcher at bfinance, noted that sovereign external debt issuance is declining while LC issuance will increase. "It's very beneficial to these governments to issue debt in local currency he said. Much of the pain experienced in the past by EM bondholders has been caused by a mismatch between the revenues EM governments earn in their local currency and their repayments in USD, particularly in periods of USD strength.

On the bigger picture, Thevakarrunai said that that EM sovereigns offered greater heterogeneity and diversification than DM corporates or sovereigns.

"Quantitative Easing inflates a lot of things at the same time. But these countries have different industries and trade circles, so there is genuine diversification"

David returned to the fact that spreads on EMD were tight at the moment, and current allocations to EMD were for long-term, strategic purposes which offer diversification.

Singh emphasized that deciphering the underlying drivers of EM sovereign debt performance and correlations required not simply numerical analysis but fundamental qualitative thinking.

Dean Wetton, founder of investment consultancy, Dean Wetton Advisory asked what the fundamental drivers of EMD were. "Quantitative Easing inflates a lot of things at the same time. But these countries have different industries and trade circles, so there is genuine diversification," he said. Wetton noted, however, the really high correlation between EMD and High Yield.

Singh responded that from a long-term asset allocator's perspective, there was low correlation on downgrades in those two segments. He remained focused on the positive trajectory for EM sovereigns over the long term.

Sovereigns Emerging from Default

Uzun added that many countries have gone through the default cycle post-COVID pandemic due to bad policies and the pandemic itself. Countries like Russia, Ukraine, Belarus, Zambia, Ghana, Sri Lanka, Belize, Surinam and Lebanon have defaulted. Currently, only Lebanon, Venezuela, and Ethiopia are in default. She believes better returns are expected over the next five to ten years.

For MFS, this is the right time to be active. Uzun mentioned that more than half of the issuance rated CCC or lower is undergoing restructuring. Countries like Zambia, Ghana, and Sri Lanka are emerging from the other side, with Sri Lanka taking three years to do so. These journeys require deep analysis, especially considering new tariffs imposed by the U.S.

Whitfield noted that downside risk was the number one lens for analysis over risk premium. He said that avoiding tail risk and being able to manage drawdown would provide protection from huge volatility. Here derivatives have the ability to play their part and so does managing exposure to HC. There was an additional consideration for a growing business such as IQUW: was it worth allocating to an active manager when a mandate might represent just 5-10% of the fixed income portfolio? "You can argue either way," said Whitfield. In the case of EMD, however, he had decided to go active because the capital flowing into the mandate could increase as IQUW continues to grow, which allows better control over active risk.

"Manager skill is very important and there is a good level of manager alpha in EMD relative to other asset classes," said Thevakarrunai. "EMD can be quite customised with different components." For pension funds who are more comfortable than insurers with longer duration, they are able to construct their EMD mandates differently and in way that better suits their own risk and return requirements.

> *Also, we are comfortable that it is being actively controlled by managers.*

Thevakarrunai explained that for some investors an unconstrained mandate can be more beneficial as HC and LC can perform meaningfully differently at different parts of the economic cycle; and having a manager than can allocate between them can add value for an investor.

For IQUW, bfinance brought forward a manager that over three years had outperformed both in up markets but also provided significant protection in down markets, showing the benefit of hiring a dynamic manager.

Uzun agreed that having a really good manager in downside risk was underappreciated. MFS is ranked 7th over the last 10 years in the eVestment universe for EMD in navigating downside market environments, which means, MFS's strategy outperformed 93% of all other managers in downside during the last 10-year period.

On duration risk, Wetton asked whether it could removed from the mandate.

Whitfield responded that there were benefits to keeping it in, such as increasing the secured spread pick-up. "Also, we are comfortable that it is being actively controlled by managers."

Whitfield added that while defaults in HC are known, they are much rarer on LC issues because sovereigns have the ability to simply print more paper.

David said that the asset allocation committee of the Lloyds Central Fund was not nimble enough to make calls between HC and LC. "Much better for us to give to one manager over the cycle, getting alpha from stockpicking and rotation over three to five years."

Thevakarrunai said it was best to have an EMD specialist which have big teams to analyse the large universe of countries and corporates which are under-researched.

Bespoke Benchmarks by Country

On benchmarks, Uzun mentioned that some MFS clients are now allowing managers to exclude up to 30% of benchmark constituents, with a focus on ESG investments. Regarding the split between HC and LC, she recommended considering correlations between the base economy of any client and EM economies to improve Sharpe Ratios. For example, institutional investors in Australia could start with 70% LC/30% HC and Canadian investors 60% LC/40% HC. The higher exposure to LC reflects both countries' economic ties as exporters of commodities to EM and high correlation of their base currencies to EM local currency debt creating a remarkable natural hedge. For US investors, on the other hand, the starting split can be closer to 70% HC/30% LC. She noted that this last kind of split has historically balanced volatility equally between HC and LC, i.e. LC is naturally more volatile.

Wetton suggested that dollar risk is best managed outside of the EMD mandate, ie active currency risk should be minimised. Currency dynamics are crucial for emerging markets investors, who have long been challenged by the strength of the US dollar. Historically, cycles of dollar dominance tend to last seven to eight years. However, Uzun acknowledged that the current cycle extended beyond a decade. She referenced the 'Dollar Smile' theory, which suggest that the dollar typically strengthens either when the U.S. economy is booming or when global sentiment deteriorates, and recession risks rise.

> *I have to yet to see any consistent framework that everyone is happy with*

Today, despite mounting concerns about a potential U.S. recession, the dollar remains weak – an unusual pattern. One explanation for this weakness is the heavy investment in U.S. financial assets over the past decade, driven by a narrative of U.S. exceptionalism. As global conditions improve – boosted by fiscal expansion in the Eurozone and the stimulus measures in China – and U.S. growth slows, some of the dollar positioning is beginning to unwind.

Adding to this shift are the chaotic and unpredictable policies of the current U.S. administration, which have led markets to demand a higher risk premium for U.S. assets. As a result, investors are increasingly diversifying away from the U.S., contributing to dollar weakness in the first quarter and continuing today.

The cio investment club roundtable finished on the topic of Responsible Investing.

Singh suggested that in spite of all efforts to be quantitative about this, weighing considerations ends up being an art. In part, this is because people weigh certain factors more prominently than others. "I have to yet to see any consistent framework that everyone is happy with," he said.

David noted that EMD does often find favour in ESG strategies because they are financially supporting developing economies.

Uzun said that MFS has a sovereign working group that evaluates the effect of various ESG factors on market prices. She noted that the effect is not static. For example, environmental factors were not important even five years ago. Likewise, the three categories have never been equally important, with governance ('G') carrying the most weight with market participants.

The MFS framework has two related benefits. First, it facilitates ranking of sovereigns on ESG factors in relation to their economic development, ie more is expected of richer nations. Second, it integrates ESG factors with traditional market influences. "It is part of the mosaic," concluded Uzun.

Participants

Rickey Thevakarrunai

CFA, Director, Public Markets, bfinance

Rickey Thevakarrunai joined bfinance in May 2023 as a Director within the Public Markets Team.

Prior to joining bfinance, Rickey spent 10 years at abrdn as a senior investment analyst covering manager selection for fixed income, equity and multi-asset funds.

Rickey holds a BSc in Economics from the University of Nottingham and is a CFA charterholder.

Katrina Uzun

Institutional Portfolio Manager, MFS Investment Management

Katrina Uzun is an institutional fixed income portfolio manager at MFS Investment Management® (MFS®). In this capacity, she participates in portfolio strategy discussions and communicates portfolio investment strategy and positioning to prospects, clients and consultants.

Prior to joining MFS in 2018, Katrina served for 11 years as an investment director at Wellington Management, where she was responsible for emerging market debt. Before that, she worked as a trader and portfolio manager at South Trust Bank for four years, handling municipal debt and US Treasury markets.

Katrina earned a Bachelor of Science degree, magna cum laude, in finance from the University of Alabama and a Master of Business Administration degree from the MIT Sloan School of Management.

Hartej Singh

Head of Public Credit, Pension Insurance Corporation

Hartej Singh is Head of Public Credit at Pension Insurance Corporation. He leads the team that runs the insurer's global investment-grade credit allocation within a £50 billion portfolio.

Before joining PIC, he managed global buy-and-maintain credit mandates as a Portfolio Manager at Janus Henderson Investors. Earlier, Hartej structured portfolio credit investments in London and New York.

He holds an MBA from London Business School, a first-class BSc in Mathematics with Economics from University College London and is a CFA charterholder.

PIC

Dean Wetton

Managing Director, Dean Wetton Advisory

Dean Wetton, BComm (Hons), MBA, CFA, Managing Director, founded Dean Wetton Advisory in 2009, recognising the need for a fresh approach to providing investment advice to clients: an approach that delivered straightforward, clear advice in a cost-effective way.

Dean has wide experience of advising clients on a range of investment issues, having previously been Head of the Manager Evaluation Function at P-Solve Asset Solutions and a senior member of Hewitt's Manager Research Team.

Dean Wetton Advisory

Anthony David

Fixed Income Portfolio Manager, Lloyd's

Anthony David CFA is a Fixed Income Portfolio Manager at Lloyds Society managing the internal assets. Previously Anthony has been a Portfolio Manager at Aviva Investors and LGPS Central.

Alastair Whitfield

Head of Investment & Treasury Management, IQUW

Alastair Whitfield is the Head of Investment & Treasury Management at IQUW, a property and speciality insurer and reinsurer. With a career spanning over 20 years, he started his career on the sell side as a bank credit analyst prior to and through the global financial crisis.

Since then, he has held a broad variety of positions responsible for the investment management of P&C and captive insurers since 2011.

He joined IQUW in 2023 to lead the build-out of the company's investment function.

In attendance

Brendan Maton (Moderator)

Director, Crayford Ash

Brendan Maton has been covering pensions and investments as a journalist for almost thirty years. He began his career at FT Business before going independent in 2003. Since then, he has chaired roundtables, moderated investor conferences and hosted the IPE channel of sponsored webcasts. He still writes on pensions and investments for IPE as well as freelancing for a host of organisations.

Kelly Tran

Managing Director, UK & Ireland, MFS Investment Management

Kelly Tran, CFA, is managing director of UK & Ireland at MFS Investment Management® (MFS®). In this role, she is responsible for new business development and consultant relations for the UK institutional market for defined benefit, defined contribution and endowment and foundation clients. She is based in London.

Kelly joined MFS in 2021 in her current role. Previously, she held various roles over a seven year period with Newton Investment Management/Bank of New York Mellon including client director, commercial sustainability leader and head of UK sales. She also spent eight years at J.P. Morgan Private Bank managing multi-asset portfolios for ultra-high-net-worth clients, covering Russia, Greece and Israel.

Kelly earned a Bachelor of Science degree from the London School of Economics and Political Science. She holds the Chartered Financial Analyst designation. She is also a steering committee member of the Diversity Project and part of the leadership team of its Race & Ethnicity group. She joined the Pensions and Lifetime Savings Association's Defined Benefit committee in 2022 to help shape its retirement income policy agenda. She also serves as a school governor of the Caterham High School in London and chairs its Finance & Resources committee.

Sean Thompson

Founder & Director, cio investment club

Sean has nearly 40 years of experience working in London's financial services sector and the insurance market. After 10 years as Managing Director of CAMRADATA, Sean launched the cio investment club on 1st January 2024.

The cio investment club's mission is to become the voice of chief investment officers and investment professionals at institutional firms. To help achieve this the club hosts events throughout the year that educate and inform, whilst providing thought-provoking content to its members.

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