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Sovereign Reversal: Why institutional allocators are rewriting the EMD playbook

In association with

Federated Hermes

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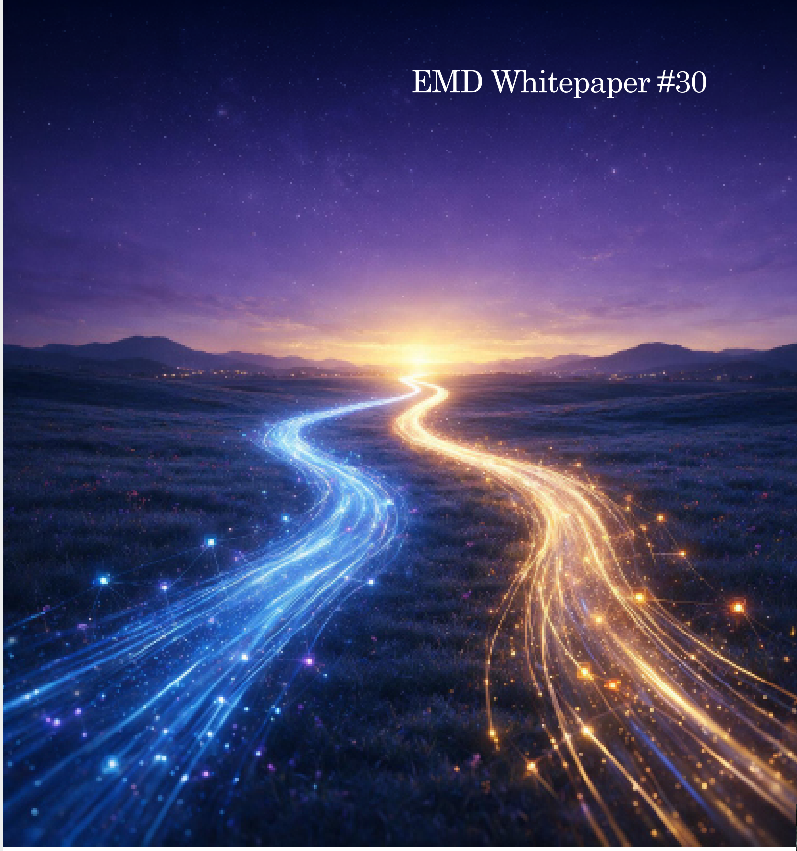

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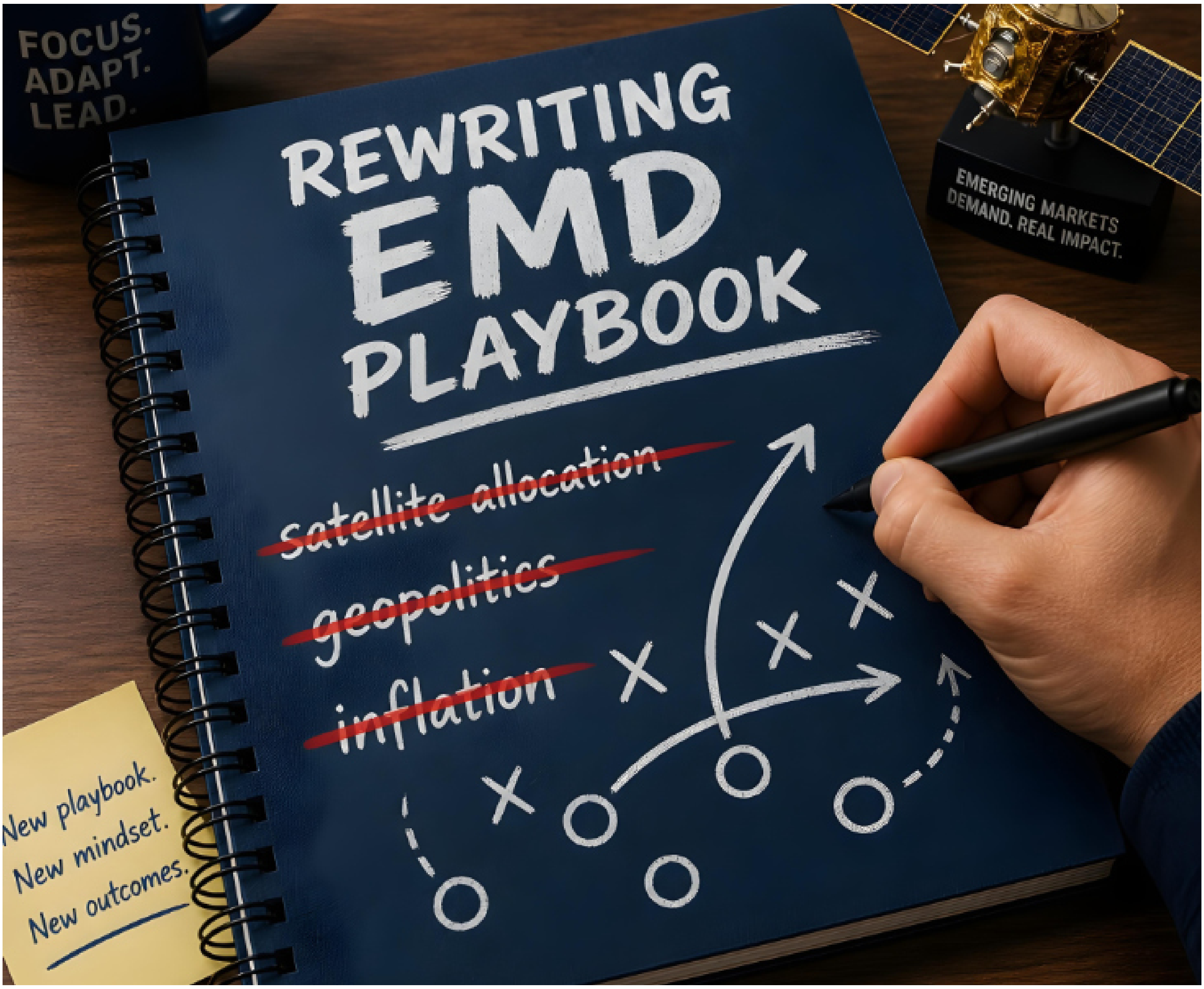
For a generation of institutional asset allocators and investors, emerging market debt (EMD) was bound by a predictable, cyclical script. It was the ultimate "risk-on" satellite allocation: an asset class to be courted when spreads looked cheap and abandoned the moment volatility rose. At the first whisper of geopolitical friction, inflationary pressure or developed market tightening, investors routinely rushed back to the perceived safety of Developed Market sanctuaries.

Yet, the macroeconomic landscape of the past decade has fundamentally challenged that traditional thinking. While mature developed markets have faced unprecedented governance shocks, political instability and deteriorating fiscal positions, many emerging economies have quietly delivered more orthodox monetary policy, stronger balance sheets and faster post-crisis recoveries.

To explore this shifting paradigm, the cio investment club hosted an exclusive roundtable in London in July. The discussion brought together leading institutional asset owners, consultants and fund managers to debate whether EMD has transitioned from a cyclical trade to a resilient, strategic, core portfolio allocation.



Macro regime shift: Dollar, deficits and divergence

The global macro regime is undergoing a structural shift. With the US dollar facing long-term structural questions and some developed bond markets struggling under the weight of twin deficits, institutional allocators are forced to reassess how they construct the defensive portion of their portfolios.

A key starting point for this reassessment is how emerging market economies have absorbed recent global shocks.

"If you look at how EM has behaved, many key countries have demonstrated remarkable resilience despite undergoing the sharpest developed market tightening cycle in forty years," observed **Laura Reardon**, Fixed Income Institutional Portfolio Manager at MFS. She explained that local central banks successfully anchored inflation and protected currencies through proactive rate hikes. "They implemented orthodox monetary policies and raised rates well ahead of the Federal Reserve," Reardon said. "This swift action fundamentally altered the risk premium that investors should demand."

This divergence between developed and developing market volatility has reframed how asset managers view fixed income stability.

"For the past few years, emerging markets have actually been the 'boring' part of global fixed income, while developed markets have provided the drama," noted **Mohammed Elmi**, CFA, Executive Director and Senior Portfolio Manager of EMD at Federated Hermes.

Pointing to the long-term erosion of US fiscal discipline, Elmi argued that dollar dominance is facing structural headwinds. "Since the middle of 2020, we have seen a gradual but clear erosion of dollar dominance," Elmi said. "The purchasing power of the dollar has entered a long-term decline, turning persistent US twin deficits into a structural tailwind for local-currency emerging market debt."

> *This swift action fundamentally altered the risk premium that investors should demand.*

From an advisory perspective, these shifting macro realities are altering pension scheme conversations. **Julian McKenzie-Smith**, Fund Research specialist at Gallagher UK, highlighted that institutional appetite varies widely depending on the client's endgame.

"While mature Defined Benefit (DB) pension schemes are heavily constrained by de-risking and buyout objectives, the broader wealth and Defined Contribution (DC) sectors are actively searching for global yield engines," McKenzie-Smith explained. He observed that these growth-focused allocators want assets "decoupled from the fiscal drag and low yields of developed markets."

Overcoming historical biases on investment committees remains a primary hurdle.

"For a long time, investment committees treated EMD as a single, highly volatile monolith to be avoided during global downturns," said **Dean Wetton**, Managing Director of Dean Wetton Advisory. However, he emphasised that EMD acts as a powerful strategic diversifier.

"The asset class offers exposure to economic cycles and political developments that are uncorrelated with developed-market equities," Wetton noted. "While political risks in emerging markets are real, they are highly diversifiable by spreading exposure across numerous sovereign issuers to dampen overall portfolio volatility."

Flows, valuations and technical signals

The shifting structural narrative is clearly visible in market technicals and capital flows. According to data from JP Morgan, EPFR Global and Bloomberg Finance, EMD attracted a substantial $30.9bn of net inflows in 2025, followed by another $17.7bn in the first eight weeks of 2026. This marked six consecutive months of positive flows, signalling what many analysts describe as the early phase of a structural reallocation rather than a short-term tactical trade.

Examining where this strategic capital is being deployed reveals a shifting institutional mindset. According to **David Will**, who leads Fund Manager Assessment at Scottish Widows, EMD has firmly established itself as a core holding rather than a satellite trade.

"We view EMD as a strategic anchor for our multi-asset portfolios," Will said. "The positive real yields on offer provide a far more compelling risk-reward profile than developed market corporate credit, though allocators must remain disciplined on valuations following recent hard-currency rallies."

To navigate these compressed spreads, investors must monitor specific technical signals across local-currency markets. **Rickey Thevakarrunai**, Director of Public Markets at bfinance, suggested focusing on the discrepancy between hard-currency spreads and local-currency real yields.

"While hard-currency spreads have compressed following prolonged rallies, local-currency real yields remain highly attractive," Thevakarrunai explained. He noted that many investors are increasingly focusing on local-currency markets, where real yields remain elevated relative to developed markets and currency dynamics could become a more important driver of returns.

A parallel shift is occurring in the funding strategies of EM sovereigns. **Matthew Holdgate**, Portfolio Manager of Fixed Income at Border to Coast, observed that sovereign borrowers are actively reducing their reliance on greenback-denominated funding.

"Sovereigns are increasingly funding themselves through deep, local-currency domestic bond markets," Holdgate said. "This growth of local-currency markets represents a major structural step forward, creating a stable domestic investor base that acts as an essential shock-absorber during global market selloffs."

> *Rather than being reliant on a single international market or currency, sovereigns now have broader funding flexibility.*

Evaluating this evolution from an insurer's credit perspective reveals a fundamental drop in structural default risk. According to **Dan Poole**, Deputy Head of Public Credit at PIC, the credit strength of sovereign borrowers has improved dramatically compared to previous cycles.

"What has really changed for sovereign issuers is their ability to tap multiple deep pools of capital," Poole explained. "Rather than being reliant on a single international market or currency, sovereigns now have broader funding flexibility. This multi-pool access marks a step-change in credit robustness and drastically reduces the systemic default risks we saw in previous decades."

Active vs. passive – EMD's issue for the ages

One of the key challenges for an investor looking to implement an EMD allocation is the long-running debate on stylistic approach. The panel debated whether passive index replication can deliver acceptable results, or if the asset class demands specialised, active management.

The structural flaws in traditional index construction make a compelling case for active management, according to Holdgate.

"Unlike equity indices, where capital is allocated to the most valuable companies, traditional debt indices award the largest weights to the sovereign nations that issue the most debt," Holdgate explained. "A passive index tracker automatically concentrates capital in the most heavily indebted sovereigns rather than the most successful ones." He said that active managers can justify their fees by "avoiding deteriorating credit stories and identifying idiosyncratic value that indices cannot capture."

Detailing MFS's active approach, Reardon outlined how her firm relies on rigorous, research-intensive country and security selection, prioritising downside risk protection over chasing raw benchmark beta. "Our investment process integrates top-down country assessment with bottom-up credit selection," Reardon explained. "We focus on favouring sovereign credits supported by strong or improving fundamentals — evaluating institutional strength, policy framework credibility and external account health. Rather than simply buying index weightings, our process deliberately avoids sovereign markets where structural vulnerabilities are not compensated by attractive risk-reward profiles."

She noted that the broad, beta-driven market rally has largely played out. "Tight credit spreads mean that future excess returns must be driven by bottom-up security selection and country dispersion," Reardon added.

For fee-constrained allocators like DC default funds, however, passive implementation is often an unavoidable compromise. Will explained that strict regulatory charge caps and fierce competition in the UK market severely limit fee budgets. "Even though active EMD managers consistently demonstrate their ability to deliver net-of-fee alpha, the rigid fee caps governing DC default funds often force allocators to rely on low-cost passive building blocks," Will noted.

A passive index tracker automatically concentrates capital in the most heavily indebted sovereigns…

Passive replication in emerging markets also carries significant hidden operational costs. Thevakarrunai warned that tracking an EMD index involves complexities that standard equity benchmarks do not face.

"Many local-currency bonds suffer from low liquidity, complex foreign custody requirements and local withholding taxes," Thevakarrunai said. "These operational hurdles mean that passive vehicles often suffer from high tracking errors, transaction drag and tax drag, which frequently make them less efficient than active alternatives on a net-of-costs basis."

To bridge this divide, McKenzie-Smith suggested that asset managers and consultants must explore more aligned pricing structures. "We need to look at fee models featuring a low base fee paired with a performance-linked component," McKenzie-Smith proposed. "This would allow fee-sensitive DC allocators to access the active management required to navigate EM dispersion without breaching their regulatory cost constraints."

Taking a blended approach

Integrating EMD into a sophisticated institutional portfolio requires careful balancing of liability management, yield enhancement and the emerging frontier of private credit.

Detailing Federated Hermes' investment strategy, Elmi outlined how his team executes a flexible, highly blended approach combining macro research with systematic credit tools.

"We evaluate four core pillars with equal weighting: central bank credibility, political stability, external accounts and fiscal metrics. We then blend sovereign, quasi-sovereign and corporate credit to capture market inefficiencies. To manage downside risk dynamically, we strictly limit individual exposure to smaller or lower-rated issuers while using credit default swaps (CDS) to hedge broad market shocks without selling core holdings."

At the longer end of the sovereign curve, specific pricing dislocations offer compelling entry points. Elmi pointed to high-quality investment-grade issuers in regions like the Middle East, where long-dated sovereign bonds issued during low-rate environments now trade at deep cash discounts. "For long-term institutional allocators, these Middle Eastern discount bonds offer a dual return engine," Elmi said. "You receive a reliable, high-running yield alongside a structurally guaranteed 'pull-to-par' capital gain as those bonds approach maturity."

Matching long-term pension liabilities within strict UK regulatory frameworks requires a highly tailored approach. Poole explained how to approach the asset class under Solvency II constraints.

"For insurers, high-quality, hard-currency EM sovereigns play a very specific role," he said. "We look for highly liquid, long-dated hard-currency bonds that allow us to achieve precise cash-flow matching against our long-term liabilities. Capturing an attractive yield premium whilst diversifying our core DM holdings makes hard-currency EMD an important tool."

Beyond public debt markets, institutional interest in private EM credit is expanding, too, driven by long-term structural trends.

Wetton noted how this part of the fixed income market in developing economies offers unique access to growth. "Private, project-level debt in emerging markets provides an attractive illiquidity premium and is highly uncorrelated with public markets," he said. "However, these private transactions demand specialised underwriting and rigorous evaluation of political, regulatory and project-level execution risks."

This long-term, illiquid approach is being actively explored by major UK asset owners. Will shared that Scottish Widows is selectively researching private EMD opportunities, particularly those aligned with global climate and energy transition objectives – yet there was complexity involved.

"To navigate the political and execution risks inherent in private EMD, blended finance is critical," Will said. "Investing alongside multilateral development banks provides the risk mitigation required to deploy institutional capital into essential development and transition projects."

Redefining ESG in EM

The integration of Environmental, Social and Governance (ESG) criteria in emerging markets is undergoing a major evolution, shifting away from static exclusionary screens toward forward-looking transition frameworks.

Rather than relying on backward-looking scorecards, McKenzie-Smith advocated for assessing a country's direction of travel.

"Early ESG frameworks effectively punished developing countries for their developmental starting points," he argued. "Evaluating a sovereign's forward-looking transition trajectory and policy commitments uncovers far more compelling investment opportunities."

This focus on transition is naturally embedded in fundamental credit research. Reardon emphasised that ESG is not an overlay at MFS, but a core component of sovereign evaluation. "Social and governance factors are drivers of sovereign spreads," Reardon stated. "Analysing institutional strength, rule of law and social stability is directly linked to credit risk. When a government takes credible steps to strengthen its institutions, improving fundamentals can create opportunities for active managers to capture alpha."

“Analysing institutional strength, rule of law and social stability is directly linked to credit risk.”

There is also a growing consensus that ESG discussions in EMD must focus on pragmatic economic realities. Elmi at Federated Hermes argued that ESG must be framed around cost of capital rather than any consensus-driven Western ethical directives.

"Highlighting how improvements in governance and transparency directly reduce a country's borrowing costs is a far more effective engagement tool," Elmi said. "Demanding immediate environmental compliance without supporting local economic development is unworkable."

From an environmental risk perspective, Holdgate added that climate analysis must prioritise practical, localised adaptation.

"For many emerging and island nations, the primary challenge is climate resilience—such as constructing weather-resistant infrastructure and establishing disaster insurance mechanisms," he said. "Evaluating these proactive adaptation measures is a critical element of modern risk management."

Managing sudden geopolitical shocks remains a crucial test for allocators. Poole raised the practical issue that credit teams face when evaluating sovereign tail risks. "From an asset owner perspective, the critical question is how you protect portfolios against unexpected geopolitical events or sudden policy shifts," he noted. "When you are investing for cash-flow matching, you need confidence that those long-term income streams will remain intact through volatile geopolitical cycles."

To mitigate these tail risks without disrupting core holdings, Elmi highlighted portfolio liquidity and synthetic hedging. "Maintaining high portfolio liquidity is our primary line of defence," Elmi explained. "We also utilise credit default swaps (CDS) as a flexible tool, allowing us to hedge broader macro and geopolitical risks without being forced to sell underlying illiquid bonds in a falling market."

For Reardon, rigorous governance analysis acts as the ultimate filter against geopolitical write-downs. She shared that MFS maintains a strict stance on sovereign risks that lack sufficient compensation. "If you look at China, we currently hold zero sovereign exposure in our active portfolios," Reardon revealed. "Chinese government spreads do not offer adequate compensation for the country's underlying regulatory, transparency and geopolitical risk profile."

Long-term outlook: Convergence and yield realities

Looking ahead to the next decade, the panel agreed that EMD's structural narrative is supported by compelling long-term megatrends and a strong yield environment.

Reaffirming Scottish Widows' commitment to the asset class, Will emphasised its enduring role in long-term portfolio design.

"When you evaluate the structural diversification and the robust real yields available in emerging markets against historically tight developed credit spreads, EMD stands out," he said. "It provides a vital yield engine for supporting our pension members' long-term retirement objectives."

Unlocking further capital from pension schemes will depend heavily on trustee education. McKenzie-Smith noted that as trustees observe how successfully EM central banks navigated recent inflation shocks, familiarity will grow. "Seeing EM policymakers demonstrate superior monetary discipline helps trustees recognise EMD as a stable, long-term allocation rather than a high-beta trade," McKenzie-Smith said.

Multiple structural megatrends will continue to underpin the asset class over the coming decade. Holdgate identified three primary macro drivers: "The global diversification of central bank reserves away from the US dollar, the vast capital required for EM climate adaptation and the rewiring of global supply chains." He noted that "these deep, structural shifts will provide active managers with fertile ground for generating alpha".

The diversification benefits also offer protection against developed market equity risks. Thevakarrunai highlighted that EMD provides a vital alternative to the extreme concentration seen in major benchmarks. "Western equity markets have become heavily concentrated in a small group of US technology giants, and EM equity benchmarks are following a similar pattern with the sharp fincrease in weight of Asian semi-conductor and memory makers," he noted. "EMD gives institutional portfolios direct exposure to completely different economic growth engines, favourable demographic trends and unlinked credit cycles."

Balancing short-term opportunities whilst remaining conscious of long-term structural shifts remains critical, according to Poole, who noted the importance of focus on current income realities given the backdrop of low credit spreads globally. "The additional return available in select sectors of public EMD are undeniably attractive," he said. "While geopolitical and macroeconomic risks must be managed, waiting for a completely risk-free backdrop means missing out on powerful compounding returns that are available in the market today."

In a global context, EMD's primary purpose remains clear. Elmi concluded by reminding the panel of the core objective of fixed-income investing: securing reliable income.

"At the end of the day, fixed income is about buying yield and EMD is the premier destination for high-quality, sustainable yield," Elmi asserted. "With headline indices yielding around 7% and active portfolios yielding close to 8%, EMD offers high-quality yield backed by tangible economic growth, maturing institutions and solid fiscal fundamentals."

Ultimately, the shift in volatility tells the most striking story. Reardon closed the session by observing that over the last few years, EM yield volatility has been lower than DM yield volatility.

"Having embraced proactive monetary policy and fiscal discipline, emerging markets are no longer seen as the primary source of global financial instability," she said. "Instead, they are increasingly serving as anchors of relative stability in a volatile global economy."

“It provides a vital yield engine for supporting our pension members' long-term retirement objectives.”

Participants

Matthew Holdgate

Portfolio Manager, Fixed Income, Border to Coast

Matthew Holdgate, CFA, is a Portfolio Manager within Border to Coast's internal fixed income team. Matthew has primary responsibility for the Emerging Market Debt sleeve of the firm's Multi-Asset Credit proposition within the £120bn local government pension scheme pool on behalf of 18 Partner Funds.

Prior to joining Border to Coast, Matthew worked for Nikko Asset Management as an Emerging Market Debt Portfolio Manager for 7 years. Before that he worked at Schroders for 9 years, for the most part, as an analyst in the multi-asset team focussing on Fixed Income, and predominantly EMD.

Matthew is a CFA charter holder with more than 20 years' experience in the financial services industry and holds a Master of Science degree in Physics from Imperial College London.

BORDER TO COAST PENSIONS PARTNERSHIP

David Will

Fund Manager Assessment, Scottish Widows

David is a Senior Manager in the Investment Office at Scottish Widows. His responsibilities include investment governance, fund manager oversight, search and selection as well as acting as the fixed income investment lead. Prior to joining Lloyds Banking Group, he worked as an investment consultant where he had responsibility for advising clients on asset allocation, manager selection, liability hedging, strategy implementation and investment governance.

David has over 30 years' industry experience and extensive knowledge of fund manager research across a variety of asset classes. One of his previous roles was that of Head of Manager Research at JLT, now part of Mercer. In addition to his role at Scottish Widows, David is a regular speaker at industry events.

SCOTTISH WIDOWS

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.

Dan Poole

Deputy Head of Public Credit, PIC

Dan is Deputy Head of Public Credit at PIC, a leading insurer of defined benefit pension schemes.

Dan leads PIC's internal USD public corporate strategy as well as overseeing external mandates in Emerging Markets and US Taxable Municipal strategies.

Dan is Chair of PIC's Asset Valuation Committee and a member of PIC's Sustainability Oversight Forum. Dan has 20 years of experience in Financial Services, holds the CFA designation and has a degree in civil engineering from the University of Nottingham.

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

Julian McKenzie-Smith

Fund Research, Gallagher UK

Julian has worked in the manager research team at Gallagher since 2025, specialising in fixed income strategies.

Covering all areas of liquid credit, he has been involved in research on absolute return, systematic fixed income and relative value credit funds.

Julian has almost two decades of experience in investment due diligence, manager selection and portfolio management, having previously worked at firms such as Man FRM, Capital Generation Partners, SEB and Deutsche Bank. He has an MSci in Physics from the University of Bristol and a PhD in Theoretical Physics from the University of Newcastle.

Gallagher

Laura Reardon

Fixed Income Institutional Portfolio Manager, MFS

Laura Reardon is a fixed income institutional portfolio manager at MFS Investment Management®(MFS®). In this role, as a member of the portfolio management team and an active participant in portfolio strategy and positioning discussions, she is responsible for ensuring the ongoing alignment of investment philosophy, process, portfolio strategy and performance.

Laura joined the firm in 2024. Prior to this, she worked in various client facing roles at Aviva Investors, Barclays and Abrdn before moving to BMO Global Asset Management, where she joined the emerging markets debt team, and most recently at Columbia Threadneedle Investments as a client portfolio manager for emerging market debt and fixed income.

Laura earned a Bachelor of Science degree in French and German from Aston University.

Mohammed Elmi

Executive Director, Senior Portfolio Manager, EMD, Federated Hermes

Responsible for portfolio management and research in the global fixed income area.

Previous associations: Director, Emerging Market Credit Strategist, Societe Generale; Vice President, Emerging Market Credit Analyst, Credit Suisse; Investment Manager, Mashreq Capital (DIFC); Product Development Manager, Bloomberg LP. B.Sc., M.Sc., University of London.

Joined Federated Hermes 2013; Investment Experience: 25 Years.

In attendance

Elizabeth Pfeuti (Moderator)

Director, Rhotic Media

Former Dow Jones staffer Elizabeth Pfeuti is a member of the Rhotic Media executive leadership team. A highly decorated journalist, Elizabeth has been in financial journalism for almost 20 years. At Dow Jones, she covered the asset management, investment banking and investor services beats for Financial News, where she also wrote on a wide range of regulatory themes.

She was previously the European Editor for CIO Magazine and boasts an exceptional contact book of buy-side and in-house institutional CIOs and asset management executives. More recently she has worked on corporate briefs for pension consultants, investment banks and asset management groups.

RHOTIC

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.

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Douglas Anderson

Executive Director, Head of International Consultant Relations,
Federated Hermes

Douglas joined in February 2017 as Head of Consultant Relations. Prior to this, he was a consultant relations manager at Lazard Asset Management Limited for five years from 2011 and at Capital International for 11 years from 2000.

He has also worked in consultant and actuarial roles at Bacon & Woodrow (now Aon Hewitt) and Hymans Robertson. Douglas holds the Investment Management Certificate (IMC) qualification and a BSc (Hons) in Mathematics from the University of St Andrews.

Federated Hermes

Henry Odogwu

Senior Managing Director, Head of EMEA Sales, MFS

Henry Odogwu is a senior managing director of institutional sales at MFS Investment Management® (MFS®). In this role, he leads a sales team focused on institutional investors across Europe, the Middle East and Africa.

Prior to joining MFS in 2026, Henry spent nearly six years at BlackRock, where he held a series of senior leadership positions, most recently serving as managing director and head of UK professional trustee relations. Before BlackRock, Henry was a managing director at FTSE Russell (London Stock Exchange Group), where he led distribution for European asset owners and continental European asset managers, banks, private banks and insurance companies.

Henry earned a Bachelor of Engineering degree with honors in mechanical engineering from Brunel University. He also holds the Investment Management Certificate (IMC) and serves as a trustee of Barnardo's, a charity where he chairs the investment committee.

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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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