Rocaton

INSIGHTS

Emerging Market Debt Revisited

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EXECUTIVE SUMMARY

* Emerging market debt has become more widely adopted across a broad spectrum of investors.
* When investing in emerging market debt, we believe investors should:
  * Make use of the widest opportunity set across the emerging market debt landscape, including hard currency, local currency and corporate bonds.
  * Avoid conventional "blended" strategies which typically have a 50% allocation to local currency debt. While local currency bonds can and should be considered as part of an emerging market debt mandate, we believe that a blend mandate implicitly requires investors to have strong conviction in emerging market currencies maintaining their value or appreciating relative to the U.S. dollar.
  * Implement emerging debt via opportunistic or hard currency strategies that can make opportunistic use of local or corporate bonds, but which are not wedded to an equally weighted hard and local currency benchmark.
  * Consider dedicated corporate emerging market mandates. EMD corporate strategies have generally outperformed our expectations recently and the availability of strategies focused exclusively on emerging market corporate exposure has expanded over the past several years making corporate debt a more viable option for investors to consider.
  * Benchmark strategies to the most diverse benchmarks such as the J.P. Morgan Emerging Market Bond Index – Global Diversified ("EMBI-GD") which incorporate country diversification rules.
* In today's environment, emerging market debt appears to offer competitive compensation relative to other asset classes and on a standalone basis given the potential risk. Investors should, however, be aware that the asset class has experienced significant inflows in recent months as investors continue to search for yield.

Introduction

Emerging market debt ("EMD") has become more widely adopted by investors in recent years, partially as a result of the strong performance the asset class has experienced over the long-term. Additionally, the credit quality of EMD USD denominated benchmark has improved over the last 15 years, even in spite of recent downgrades (e.g. Brazil). As of June 30, 2016, over 50% of the JP Morgan EMBI GD index was rated investment grade. Beyond the strong performance and improving credit quality, there is also a growing list of strategies which investors can choose from leading to increased adoption. We believe EMD investors should make use of a wide opportunity set, but utilize a U.S. dollar-denominated benchmark. In our opinion, most investors should implement via opportunistic strategies or hard currency strategies which make use of hard currency bonds as well as local currency and corporate bonds. Blended mandates which have a neutral allocation of 50% local currency, in our opinion, require accepting too much volatility and uncertainty around the direction of the

U.S. dollar relative to emerging market currencies. The balance of this paper will detail our rationale for these recommendations, provide guidance on benchmark selection and provide our thoughts on the current outlook for EMD.

Figure 1:
Emerging Market Debt Performance as of August 31, 2016

		Annualized Return			Annualized Risk		
Market	**Index**	**5 Years**	**10 Years**	**15 Years**	**5 Years**	**10 Years**	**15 Years**
Hard Currency (U.S. $)	J.P. Morgan EMBI GD Index	6.7%	7.7%	9.4%	6.8%	8.8%	8.4%
Local Currency Bonds	J.P. Morgan GBI-EM GD Index	-2.4%	5.2%	N/A	12.8%	13.1%	N/A
Corporate Bonds	J.P. Morgan CEMBI Broad Diversified Index	5.9%	6.6%	N/A	5.4%	8.5%	N/A
Public Equity	*MSCI ACWI Index*	*8.9%*	*5.0%*	*6.3%*	*13.0%*	*17.0%*	*15.9%*
Core U.S. Fixed Income	*Barclays Aggregate Index*	*3.2%*	*4.9%*	*4.9%*	*2.6%*	*3.2%*	*3.5%*

Sources: JP Morgan, Rocaton.

Strategy Selection

For most investors, emerging market debt often represents a modest portion of their total portfolio assets (generally less than 10%). Therefore, institutional investors typically utilize one or two EMD managers to gain exposure to the asset class (larger investors may have three or more EMD mandates). As we have already outlined, we have a preference for opportunistic or hard currency mandates. In our view, dedicated local currency or blended mandates with 50% local currency should be secondary considerations.

Blended strategies have historically experienced higher volatility relative to hard currency strategies given the augmented currency risk. Over the last 10-years, hard currency EMD had a realized volatility of 8.8% while a 50/50 mix of hard and local currency had a volatility of 10.4%[1]. Beyond the increased volatility, there are other reasons for avoiding blended

Figure 2:
Emerging Market Debt Mandates

Mandate Type	Rocaton View	Pros	Cons
Hard Currency	Recommended	• Straight-forward • Lower Volatility	• Narrow opportunity set
Local Currency	Consider obtaining local exposure via opportunistic mandates	• Straight-forward	• Higher volatility • Narrow opportunity set
Blended	Consider mandates that are not tied to a 50/50 benchmark	• Broader opportunity set	• Higher fees than hard currency • Poor active management results
Opportunistic	Recommended	• Broadest opportunity set	• More reliance on skill • Limited universe of quality managers
Corporate	Consider dedicated exposure as part of a multi-manager structure	• Potential for return enhancement	• May be difficult to benchmark

1 Volatility defined as annualized standard deviation. Results based on monthly index data measured through August 31, 2016.

strategies. Notably, actively managed blended strategies have not performed well on a relative basis, largely due to the challenges of successfully allocating between hard and local currency on a tactical basis. Additionally, blended strategies often carry higher fees (generally ~15 basis points higher) relative to hard currency mandates. Lastly, there is a withholding tax on coupon payments for local currency mandates which has the potential to detract 20-30 basis points annually from the stated index return.

We would prefer dedicated hard currency mandates that have the ability to tactically allocate to local currency and corporate bonds. Opportunistic mandates may be appropriate for investors less concerned about tracking a benchmark. As the name implies, opportunistic strategies have a broad opportunity set (including the ability to short bonds or currencies) and tend to have more of an absolute return focus.

Corporate Emerging Market Debt

For investors who are considering a structure which includes more than one strategy, we would urge investors to consider a dedicated emerging market corporate debt mandate. In terms of sizing, we believe investors should generally have no more than 50% of their total EMD exposure allocated to a dedicated corporate strategy. The emerging market corporate (USD-denominated) landscape has grown significantly over the last 15 years and, more importantly, there are now a number of products for investors to consider. There are several compelling reasons why we believe investors should consider a dedicated emerging market corporate mandate including:

* Similar default and recovery rates for emerging corporates compared to U.S. high yield corporates.
* Lower leverage levels for emerging corporates in both the investment grade and high yield segments of the market relative to their U.S. counterparts.
* Better compensation (i.e. higher yields and spreads) for emerging corporates relative to U.S. corporates across the credit quality spectrum.
* Relatively broad country diversification (top five countries within the J.P. Morgan CEMBI Broad Diversified include: 9% China, 7% Brazil, 6% Russia, 6% Mexico, and 6% Hong Kong as of June 30, 2016).
* A larger and more stable investor base. According to eVestment, there was $50 billion in dedicated emerging corporate mandates as of March 31, 2016, up from $12 billion five years ago.

Historically, we were less supportive of dedicated mandates for emerging corporate bonds. The downside risk we expected for the asset class has not materialized, despite the headwinds that the asset class has faced. Given the resilience that the asset class has shown, we believe investors should consider dedicated allocations to emerging market corporates if their allocations are large enough to warrant multiple managers. Critics of emerging market corporates typically contend that there is an asset/liability mismatch for emerging market corporations which borrow in U.S. dollars, but have revenues which are denominated in local currencies.

We would counter that argument by pointing out that emerging market corporations often have U.S. dollar revenues to offset part of that mismatch. Further, many emerging market corporate borrowers are able to hedge the currency risk inherent in their liabilities and, as we have already pointed out, the lower leverage levels for emerging market corporates helps further alleviate any asset/liability mismatch. Consider the prior three-year period which looked to be a perfect storm for emerging market corporates as energy prices fell sharply and many emerging market currencies experienced significant declines relative to the U.S. dollar. Despite this environment, the default environment for emerging market corporates has been relatively benign[2]. There are additional risks with investing in emerging market corporate bonds which are not too dissimilar to the risks inherent in U.S. corporate bonds and emerging market equities. These risks include overleveraged capital structures, poor corporate management and a general sell-off in risk assets. We believe these risks are shared by many asset classes and we are supportive of a dedicated allocation to emerging market corporate debt.

Benchmark Selection

After developing an appropriate structure, investors should pay careful attention to benchmark selection. J.P. Morgan, the primary index provider for emerging market debt, offers a number of indexes to choose from across hard currency, local currency and corporate debt. We recommend that investors use the "Global Diversified" series of indexes for sovereign exposures and the "Broad Diversified" series for corporate debt. Within the sovereign portion of the EMD universe, the Global Diversified series limits individual countries to a maximum weight of 10%. This results in a more evenly balanced exposure across countries. Uncapped indexes (i.e., the J.P. Morgan "Global" series) can have significant country concentrations such as the 40% weight to the top five countries in the J.P. Morgan EMBI Global Index. Similarly, we prefer the Broad Diversified indexes for corporate exposures to avoid concentration issues and to allow for the broadest opportunity set[3].

Current Investment Outlook

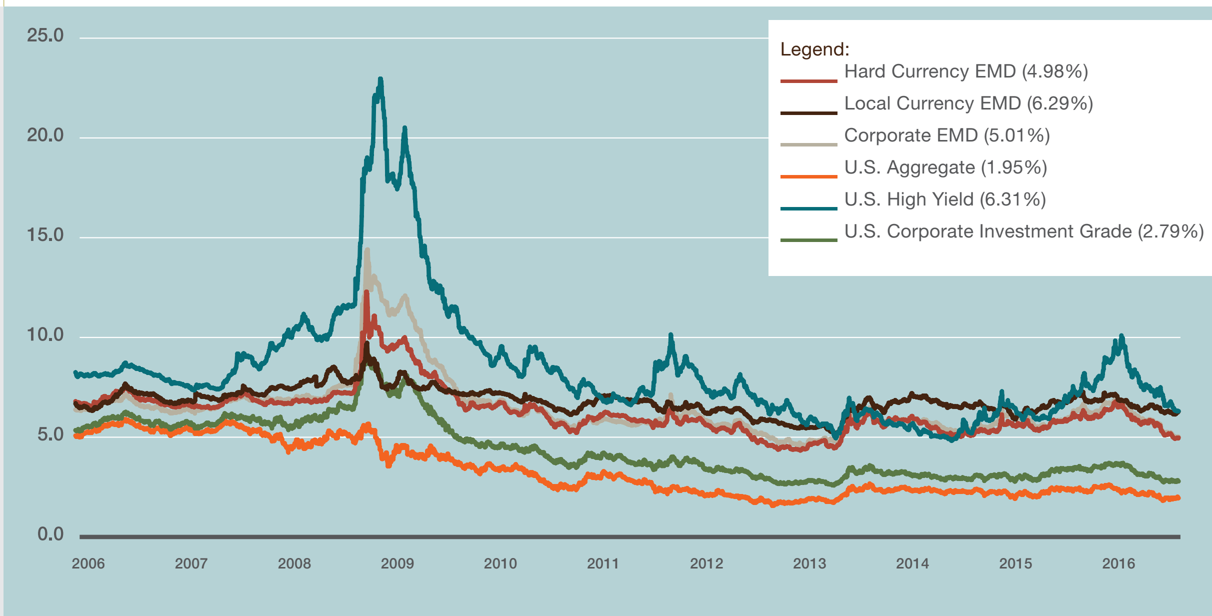
In a market environment characterized by low yields, emerging market debt appears to offer competitive compensation for the risk investors take on by investing in the asset class as hard currency exposures offer a yield of approximately 5% today. Although the price of EMD hard currency bonds has historically had an unstable relationship with changes in Treasury yields it should be noted that the index has a duration of approximately 7 years. In a rising rate environment, investors may incur mark-to-market losses. Additionally, it is important to note that the index yield is somewhat inflated by Venezuelan bonds which are trading at distressed

2 Default levels for emerging market corporates were sub-4% annually over the last three calendar years. These results were similar to those experienced by U.S. high yield.

3 The JPM CEMBI Broad Diversified includes all fixed rate, floating rate, amortizing, and capitalized interest bonds while the CEMBI (narrow) includes just fixed bullet bonds and only the two largest instruments from any issuer.

yields. We estimate that without the inclusion of Venezuela, hard currency emerging market debt yields are closer to 4.5%. While this might not sound like a compelling yield, note that the Barclays Aggregate is currently yielding 1.9%, U.S. investment grade corporates 2.8% and U.S. high yield 6.3% (see current yields in Figure 3). For investors who are considering emerging market corporate debt, the yield today is approximately 5.0% and carries an average rating of investment grade. We believe emerging market debt can provide mid-single digit returns yields over the next 3- to 5-years while offering some level of downside protection relative to public equities[4].

Figure 3:
Fixed Income Market Yields (%)



Sources: Bloomberg, Factset. Based on daily data through August 31, 2016.

Conclusion

We believe investors should maintain allocations to emerging market debt and may want to consider adopting EMD as a strategic asset class if they do not currently have exposure. While the yields on the asset class are relatively modest, we believe the asset class can provide a level of downside protection relative to public equities, particularly U.S. equities which have elevated valuations. We would prefer investors primarily gain exposure to the asset class via hard currency or opportunistic mandates as opposed to dedicated local or blended mandates that have a high neutral allocation to local currency. For investors who wish to utilize more than one strategy, a dedicated corporate emerging debt mandate has the potential to play a role in a diversified portfolio.

4 It should be noted that there is a fairly wide range of potential outcomes for emerging market debt based on our capital market forecasts. Over the next three years, the delta between our 95th and 5th percentile expected compound returns is approximately 11%.

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Disclosures

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