# Emerging-market debt investing: A Nordic perspective

Enhancing fixed-income portfolios through a strategic allocation to emerging-market debt

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## SUMMARY

- Nordic-based investors are seasoned investors in emerging-market (EM) debt and often have a strategic allocation to either hard currency or local-currency debt, or both.
- Danish institutions, which have been investing in EM debt for more than a decade, allocated 4.1% to the asset class in 2015.
- There is growing interest in blended strategies that incorporate corporate and even frontier-market debt. However, there is also increasing uncertainty as to how to allocate to the asset class.
- Investors looking for broader access to the EM debt opportunity set often look at a straightforward top-down blend of index-like positions.
- Eaton Vance (EV) believes such an approach is not the best choice. Instead, EV favours an active, unconstrained approach that focuses on detailed risk factor analysis across the tradable universe.
- Successful investment in this asset class requires specialist expertise and extensive resources.

## Foreword

Nordic-based investors, recognising the long-standing investment challenges facing institutions, are again exhibiting their receptiveness to investment solutions that lie outside the historical comfort zones of their local investment universe. Recent years have seen Nordic-based investors allocate meaningfully to global real estate and private equity assets, and today, other alternative asset classes have also come into sharper focus. With interest rates in many European countries – including Denmark and Sweden – seemingly anchored in negative territory, investors in the Nordic region are continuing to show greater interest in alternative credit.

Against this backdrop, Eaton Vance Management (International) Ltd. (EVMI) has partnered with consulting firm Kirstein A/S to publish a series of reports for Nordic-based investors that look into the dynamics of investing in alternative credit.

Eaton Vance Management (EVM) is a long-standing investor in a wide range of income-generating asset classes, both traditional and nontraditional. Kirstein A/S, since 2005, has been gathering invaluable views and data points on investor behaviour in the Nordic region. Our combined efforts will, we hope, provide you with insights about the challenges and opportunities in this space.

In this, the third of our combined reports (following on from our high yield and leveraged loans papers), we focus on emerging-market debt. The first part of this paper explores investor preferences and perceptions on emerging-market debt in the Nordic region, informed by the insights of Kirstein's market intelligence unit. The second part of the paper, written by EVMI, seeks to lay out the case for a strategic approach to this asset class that goes beyond top-down, index-based investing and affords the investment manager the flexibility to allocate freely across the full opportunity set.

We hope you find this paper informative and insightful.

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# Part One: Kirstein A/S – A Nordic Perspective

Interest in emerging-market debt remains high, but Nordic-based investors are increasingly uncertain as to how they should allocate to the asset class.

## Background

Nordic-based investors have invested in emerging-market debt for many years and are generally comfortable with the asset class as well as the diversification it offers. Nordic investors first started venturing into hard currency emerging-market debt around 15 years ago. Since then, the level of sophistication and familiarity with the asset class has continued to grow as the assets and issues in emerging-market debt have increased.

Among Nordic investors, Danish and, in particular, Finnish investors, were first movers in terms of allocating to emerging-market debt. In the last decade, Swedish investors have followed suit. Conversely, interest among Norwegian investors has historically been more subdued.

Nevertheless, interest in emerging-market debt has been fairly stable in the Nordics. The current market environment, characterised by low yields and political uncertainty in the developed markets, provides sound reasons as to why Nordic investors should continue having exposure to emerging-market debt.

## EM debt – a strategic allocation in fixed-income portfolios

Given Nordic investors' familiarity with emerging-market debt, it is generally viewed as a strategic allocation within a broader fixed-income portfolio. As such, the main question for the majority of investors regarding allocation to this asset class is not if, but rather how they should be allocated. As the Nordic region's generally most seasoned credit investors, Danish and Finnish institutions tend to have a longer history in investing in emerging-market debt compared to their Nordic peers. Looking, for example, across the defined benefit scheme offerings of 17 commercial as well as labour market pension funds in Denmark, the allocation to emerging-market debt was, on average, 4.1% in 2015.

Historically, investors have been allocated to either one emerging-market debt hard currency or one local-currency mandate, or a mixture of separate mandates.

> "Emerging-market debt has developed a lot over the last few years, and it is important to find the right approach to the market instead of a traditional split of hard and local currency. That is yesterday's news." (Swedish investor)

However, in recent years, interest in blended mandates, where investors will let external managers handle the top-down allocation, has become more pronounced.

## The search for yield

The low interest-rate environment has created several issues for Nordic pension schemes, not least the search for yield. Furthermore, it has spurred the move from defined benefit to defined contribution schemes, resulting in a shift in allocation from high-grade bonds to more risky asset classes in credit and alternatives. To this extent, a natural extension of moving along the credit continuum has been to allocate to emerging-market debt. Relative to developed-market credit, including plain vanilla high-yield and senior bank loans, the case for emerging-market debt has been the long-term risk/return relationship in emerging countries, which is seen as favourable compared to their developed counterparts.

> "We are long-term investors in emerging-market debt and believe in the opportunities it has to offer." (Norwegian investor)

Another aspect which appeals to investors is the increased diversification emerging markets offer compared to developed high-yield bonds, which typically are more correlated with exposures to developed-market equity.

The implementation of Solvency II turned out to be somewhat of a non-issue in terms of asset allocation, as Nordic investors in general were well-prepared for it. From a Solvency II perspective, emerging-market debt is treated similarly to investment-grade bonds and high yield as it does not distinguish between emerging and developed issuances in terms of capital charges.

## Development in interest and market environment

With an interest in emerging-market debt initially oriented towards hard currency, Danish and Finnish investors, in particular, have, over the course of the last decade, also considered emerging-market local currency and corporate debt respectively. Exhibit A shows the interest in emerging-market debt as a whole, as well as interest in different approaches to the asset class. Nordic investors were asked to state their interest on a scale from 1 – 5. Investors were only able assess their interest in the subclasses if their overall interest in emerging-market debt was equal to or above 3.

In terms of regional differences, Danish and Finnish investors tend to have a broader scope of what managers can invest in, and the interest in corporate, frontier and blended emerging-market debt strategies is therefore most pronounced in these countries.

Norwegian investors have been more hesitant to include emerging-market debt into their portfolios. One reason is the correlation to commodity prices. Furthermore, Norwegian and Swedish investors will typically look at more vanilla mandates and they tend to have a greater interest in local over hard currency.

While many investors today maintain an allocation to both hard and local currency, a clear finding of the 2016 Kirstein Intelligence study is that several investors are exploring the virtues of including corporate bonds and frontier-market bonds in their allocation.

> "We are starting to look at frontier-market debt, where we see opportunities going forward."
> (Danish investor)

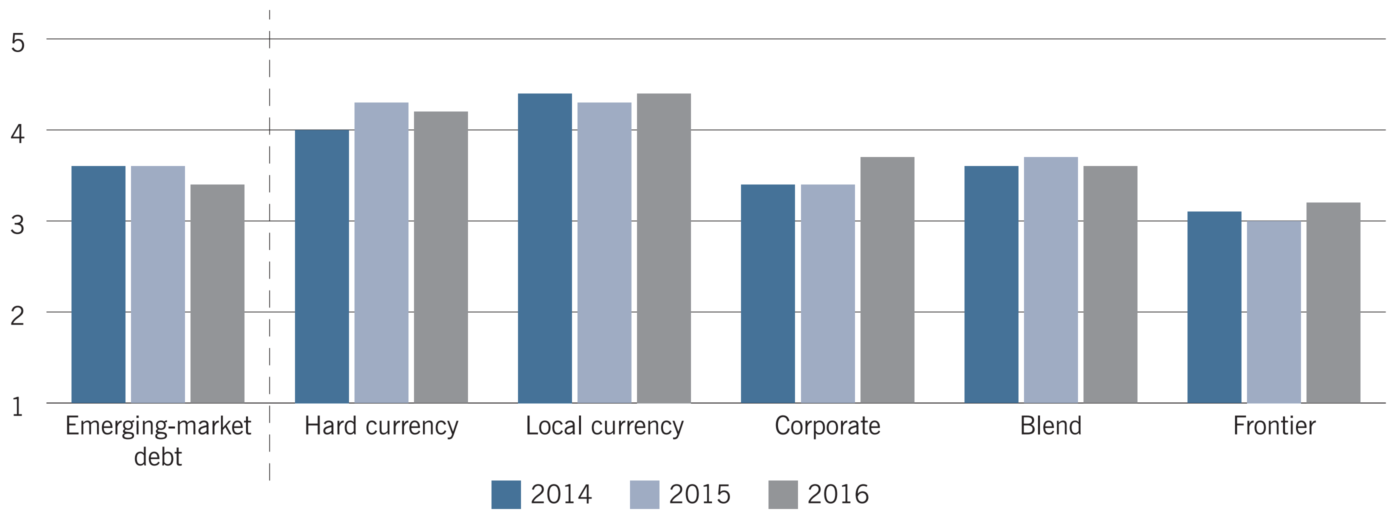
With the development of emerging corporate debt markets, some investors have indeed questioned whether their current allocation to corporates is sufficiently in line with the market. Moreover, as investors have become more comfortable with emerging-market debt, and hand-in-hand with an increase of the investable universe, some of the more experienced investors have more recently looked at the optimality of constructing blended mandates, including the role played by corporate bonds.

## Getting the risk factors right

Recent years' high volatility has been a major factor affecting Nordic investors' interest in emerging-market debt, in turn leading even very sophisticated investors to question how best to approach the asset class: whether to take a passive approach, internalise the asset class or indeed have an active approach through external managers.

The large geopolitical risks, as well as a lack of liquidity of certain issues, has meant that passive investing has been less of a theme in relation to emerging-market debt. One argument against passive investing centres on the ease of getting into certain issues and the subsequent difficulty in exiting during sell-offs, thus proving the complexity of replicating benchmark returns.

**Exhibit A** Interest in emerging-market debt among Nordic investors.




Source: Kirstein A/S as at 31 July 2016. The 2016 figure is for the year to 31 July 2016.

> "The currency aspect in emerging-market debt is difficult to grasp. And several countries are just too risky from a political point of view; take Russia for example." (Norwegian investor)

Some investors, particularly those in Denmark and Finland, have explored internal management of emerging-market debt, not least in an attempt to lower investment costs. One could argue that internalising emerging-market debt requires significant resources, and will therefore mostly be a relevant scenario for sophisticated and typically also larger investors. At Kirstein Intelligence, we have observed cases of internal management in the Nordics within both local and hard currency mandates, but the newer subclasses of corporate and frontier markets will often be outsourced due to their higher default risk.

Attempts at internal management are, however, quite new, and therefore it is still early days in terms of evaluating how internal management of emerging-market debt measures up with external management. Generally speaking, the many macro factors which can affect different types of emerging-market debt issues will lead some investors to seek the assistance of external asset managers, with substantial resources capable of handling top-down allocation to the separate sleeves.

> "We prefer top-down focused managers in emerging-market debt because using a bottom-up approach can be way too simple-minded. I mean, you can never neglect the macro economy." (Danish investor)

In instances where investors let internal teams handle their emerging-market debt exposures, it will, of course, be assumed that the investors are confident that their resources match those of the external asset manager/s, and/or that internal management comes at a lower cost.

Going forward, investors will increasingly demand that emerging-market debt managers are capable of addressing macroeconomic turmoil, lack of liquidity as well as currency risk.

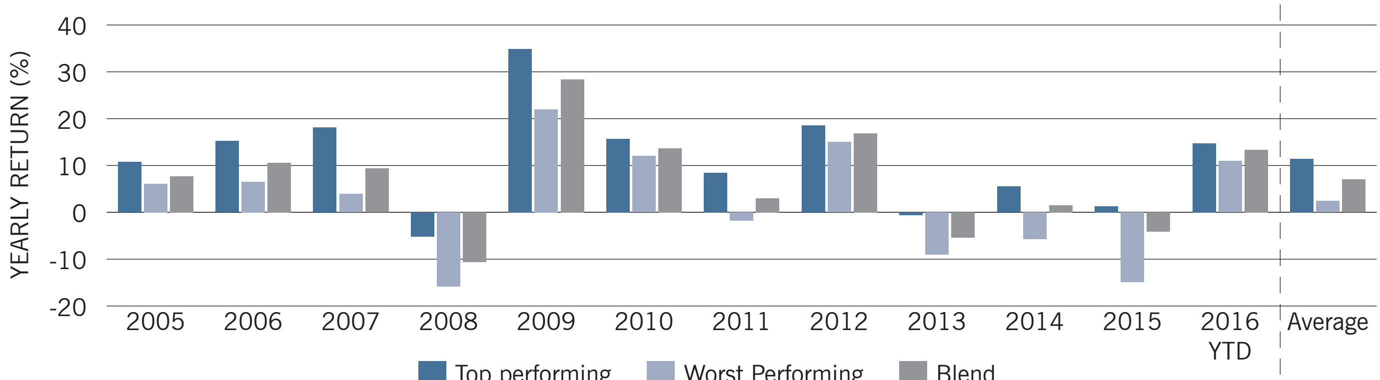
> "Admittedly, it is difficult to get the allocation right in emerging-market debt." (Swedish investor)

With the asset class having large political risks, investors will often evaluate managers on their ability to create top-down value, as some managers, who are too bottom-up focused will struggle if they run into macroeconomic headwinds.

The risk factors of emerging-market debt will of course depend on the approach taken to the asset class. With hard currency comes credit risk, whereas local currency introduces currency risk. The returns of the separate emerging-market debt sleeves differ substantially year-on-year. Exhibit B illustrates the best and worst returns among the three sleeves (hard, local and corporate bonds) over the past decade, as well as the returns for a blended approach consisting of an equal-weighted allocation to each sleeve. Return figures for each sleeve are based on commonly used indexes: the JP Morgan EMBI Global Diversified (hard currency sovereign debt), the JP Morgan GBI-EM Global Diversified (local-currency government debt) and the JP Morgan CEMBI Broad Diversified (corporate debt).

The large differences in returns, in our view, will favour blend as a more defensive approach, unless, of course, investors are capable of getting the underlying risk factors right.

**Exhibit B** Differences in returns in emerging-market debt.




Source: Kirstein A/S as at 31 July 2016.

# **Part Two:** Eaton Vance – Assessing Different Investment Approaches

We believe investors should consider an active, unconstrained approach to EM debt that focuses on detailed risk factor analysis across the tradable universe.

## Introduction

Emerging-market economies and their capital markets continue to have strategic significance for institutional investors. These economies today collectively account for more than 55% of global GDP and are projected to drive more than 75% of world growth in 2016.[1] Notwithstanding the difficulties that so many of them face, the International Monetary Fund (IMF) forecasts output growth of 4.2% for emerging-market and developing economics in 2016, more than double the 1.6% figure for advanced economies.

Today, emerging- and developing-market countries are, by and large, gradually becoming more integrated into the global monetary system. In October 2016, for example, the Chinese renminbi joined the elite ranks of the US dollar, euro, yen and UK pound as an IMF global reserve currency. Looking forward, EM debt markets are expected to grow and diversify further as EM nominal GDP increases, capital accounts gradually liberalise, local pension funds continue to develop and new sub asset classes emerge (e.g., China's municipal bond market).

Most Nordic institutional investors correctly see within the developing EM debt universe its strategic potential to add both diversification and added return benefits to a broader fixed-income portfolio. However, as they and other investors have discovered, this is a complex asset class with many idiosyncracies. Decisions on an appropriate allocation strategy and investment approach are not straightforward, and investors have had varying degrees of success to date with their EM debt allocations.

## The changing face of EM debt

Over the past 15 years, EM debt investing has evolved beyond US dollar-denominated sovereign bonds with the explosive growth in local-currency debt markets as well as the rise of investment opportunities in less-developed countries seeking to develop their capital and securities markets. As shown in Exhibit E, local-currency debt, shown in equivalent US dollar terms for comparative purposes, is a larger investment universe than hard currency debt. Hand in hand with this rapid expansion in the investment opportunity set has been considerable growth in the number of EM debt indexes, as shown in the abridged timeline.

**1991:** JPMorgan Emerging Market Bond Index (EMBI) – Government US dollar-denominated debt, originally composed only of Brady bonds – debt whose principal was backed by the US.

**1993:** JPMorgan Emerging Market Bond Index+ (EMBI+) – The first expansion of the index beyond Brady bonds.

**1999:** JPMorgan Emerging Market Bond Index – Global (EMBIG) – Government US dollar-denominated debt, with relaxed criteria to include more issuers than in the EMBI+. Currently the most commonly used EMBI benchmark.

**2005:** JPMorgan Government Bond Index-Emerging Markets (GBI-EM) – Local-currency sovereign debt.

**2007:** JPMorgan Corporate Emerging Markets Bond Index (CEMBI) – Hard currency corporate debt.

**2011:** JPMorgan Next Generation Markets Index (NEXGEM) – Hard currency debt of lower-rated sovereign issuers.

This rapid expansion in the EM debt universe has both positive and as well as challenging aspects. On the one hand, its overall evolution makes for a larger and more diverse opportunity set, and offers new risk factors for foreign investors: currency exposure, local rates and corporate credit. On the other hand, nonhomogenous growth in the sector has introduced a greater level of complexity to EM debt investing. Decisions relating to investment strategy, governance, execution, operational issues and cost are far from straightforward.

## A challenging asset class

Investors face many decisions in relation to EM debt: when to own certain subasset classes, how to switch between them, how to implement investment decisions,

[1]Source: IMF World Economic Outlook, October 2016, pages 19,207, 228; IMF World Economic Outlook database, October 2016.

how to manage developed-market risk embedded in hard currency EM debt benchmarks (e.g., Treasury yield curve changes), which benchmark to choose and whether to own local-currency EM debt when the US dollar or euro is strong. Various idiosyncracies of investing in this diverse asset class also come into play. For example:

- Indexes are a poor representation of the true opportunity set;
- Larger markets are not necessarily less volatile, easier to analyse or easier to trade;
- EM local-currency debt is much more difficult to trade than EM hard currency debt;
- Regulations for foreign investors relating to access, holding periods, tax and repatriation of monies change frequently and typically do not follow a linear progression path; and
- The cost of building index-like portfolios in this space is much higher than for passive portfolios tracking developed fixed-income asset classes.

These challenges are compounded by market volatility, major disparities within the asset class and a propensity for fairly sudden shifts in fundamentals.

Disparities within this asset class can, for example, be evidenced in the very uneven year-on-year output growth prospects among developing countries for 2016. Brazil (-3.3%), Nigeria (-1.7%), Russia (-0.8%) and South Africa (0.1%) will lag far behind China (6.6%) and India (7.6%), according to the IMF's October 2016 World Economic Outlook report. Overall, the outlook for commodity exporters is markedly different to that for commodity importers.

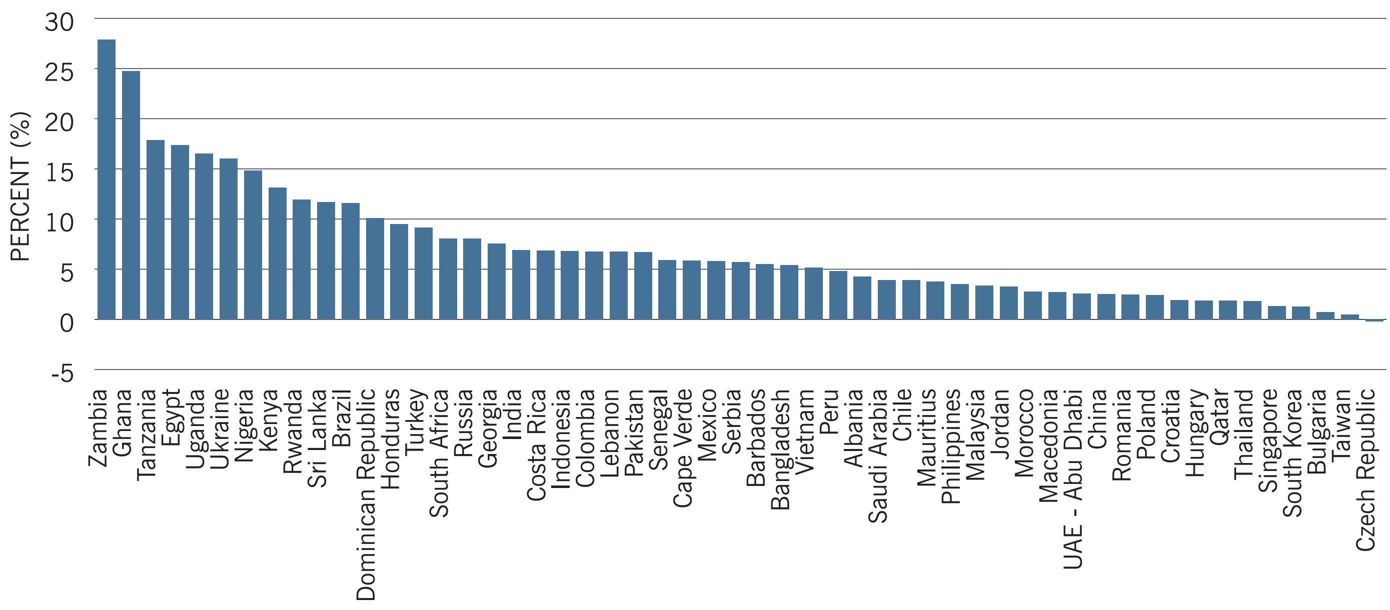
Disparities are also apparent if one looks at EM bonds in terms of their component risk factors (currency, interest rates, sovereign credit spreads and corporate/loan credit spreads). For example, nominal interest rates vary considerably across EM countries (see Exhibit C).

Further, individual risk factors can experience major changes over short time periods. For example, analysis of component returns for the JPMorgan GBI-EM Global Diversified Index shows FX moves adding 5.68% of the 17.07% total year-to-date return (as at 30 September 2016). However, the third quarter of 2016 paints a far less upbeat FX picture, with meaningful weakness among some large weight index currencies relative to the US dollar weighing on returns (see Exhibit D).

## Allocating to EM debt: The status quo

Pension fund boards which decide to allocate to EM debt typically do so with reference to the composition of one or more indexes. This means mandates are usually passive –

**Exhibit C** Five-year nominal interest rates vary greatly across countries.




Source: Eaton Vance proprietary data and calculations, as at 30 September 2016. Data provided is for informational use only. Past performance is no guarantee of future results.

or a variant on passive (e.g., rebalancing index exposures according to an a priori allocation decision) – or "constrained active," where an active investment manager's ability to deviate from a benchmark is limited. Constraints could, for example, include narrow tracking error limits and limited flexibility to allocate to off-benchmark issues.

The prevalence of index-like or index-constrained strategies appears to reflect both the complexity of the asset class and pension fund governance practice. Asset studies that predate portfolio recommendations to the board of directors of a pension fund tend to start with analyses of different indexes. Analysis of the return and risk behaviour of an index or indexes becomes, almost imperceptibly, the reference point for allocation decisions and, in turn, a benchmark for the management of that allocation. The conflation of index (or indexes) and benchmark then defines, to a considerable degree, the investment universe for that allocation. EM fixed-income indexes afford ready understanding and peace of mind for boards seeking proper execution of their fiduciary duties. Despite flaws in EM debt indexes – discussed later on – it is very seldom that pension fund boards approve a mandate with a fully unconstrained benchmark.

A further explanation for the preponderance of index-based strategies could be difficulties pension funds have experienced in finding a sufficient lineup of active investment managers having the expertise and capability to undertake detailed country-by-country analysis and to trade off-benchmark exposures in a cost-efficient manner. Interestingly, if one looks at the composition of EM debt indexes, the countries included tend only to be those markets in which the index provider – usually an investment bank – is trading. Local-currency markets – operationally more difficult to trade than hard currency EM bonds – are not well covered in EM local-currency indexes. For pension funds, recognition that successful management of the various underlying risk factors in this asset class is not easy may also lend weight to the status quo.

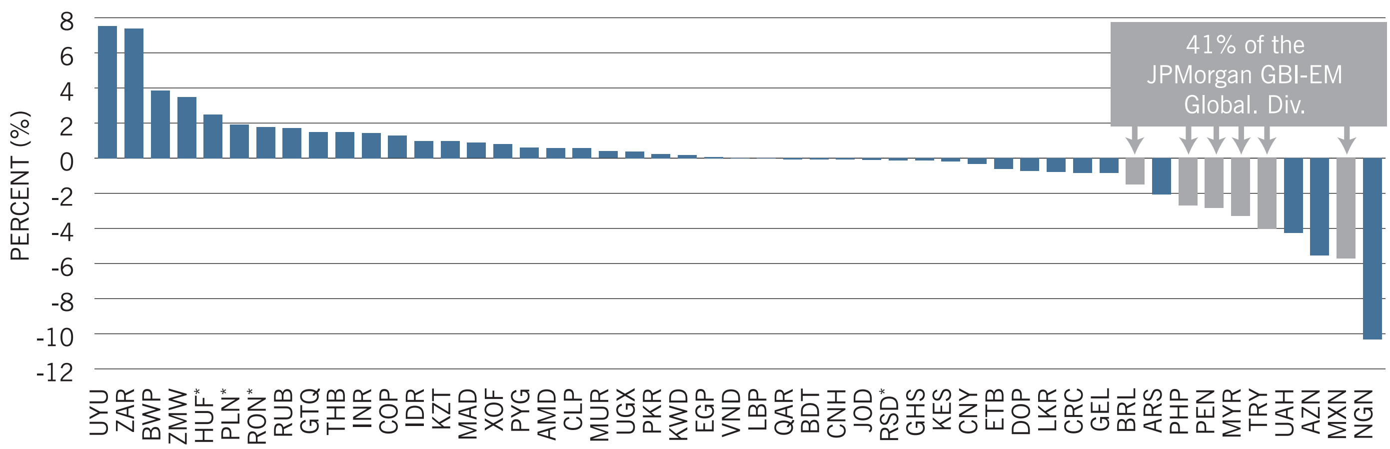
## Flaws in the index-based allocation approach

At Eaton Vance, we believe index-constrained approaches are not the best choice. The key reason lies in the inadequacy of the indexes themselves. As can be seen from Exhibit E, the EM tradable debt universe remains much larger than what is implied by the indexes in this asset class. Local-currency indexes, such as the JP Morgan GBI-EM Global Diversified Index, are a particularly poor representation of the associated opportunity set. Index composition, as mentioned previously, tends to reflect the business operations and trading behaviour of the issuing entity. There is often no compelling investment reason why certain countries are excluded from an index.

Limiting the investment scope of a portfolio manager to the constituents of a benchmark index, or a small deviation from those constituents, means the portfolio is largely unable to capture attractive off-benchmark opportunities and may also be at risk of having to hold meaningful positions in markets and securities whose fundamentals or relative valuations are deteriorating.

Research by Eaton Vance Management (EVM) conducted in August 2016 also suggests that the diversification

**Exhibit D** Currency returns: JPMorgan GBI-EM Global Diversified Index (3Q 2016).




Sources: Bloomberg, Eaton Vance. *Versus euro. Data provided is for informational use only. Past performance is no guarantee of future results.

**Exhibit E** The tradable EM debt universe is much larger than EM indexes suggest.

| | Local Sovereign | | External Sovereign | | Corporate | | Loans | |
|---|---|---|---|---|---|---|---|---|
| | JPM GBI EM Global Diversified | Broad Universe | JPM EMBI Global Diversified | Broad Universe | JPM CEMBI Broad Diversified | Broad Universe | N/A | Broad Universe |
| **Countries** | 15 | 80 | 65 | 80 | 51 | 80 | N/A | 40 |
| **Market Value** | $715 bn | $2+ tn | $420 bn | $1+ tn | $377 bn | $700+ bn | N/A | $400 + bn |

Sources: Eaton Vance and JP Morgan as at 30 September 2016.

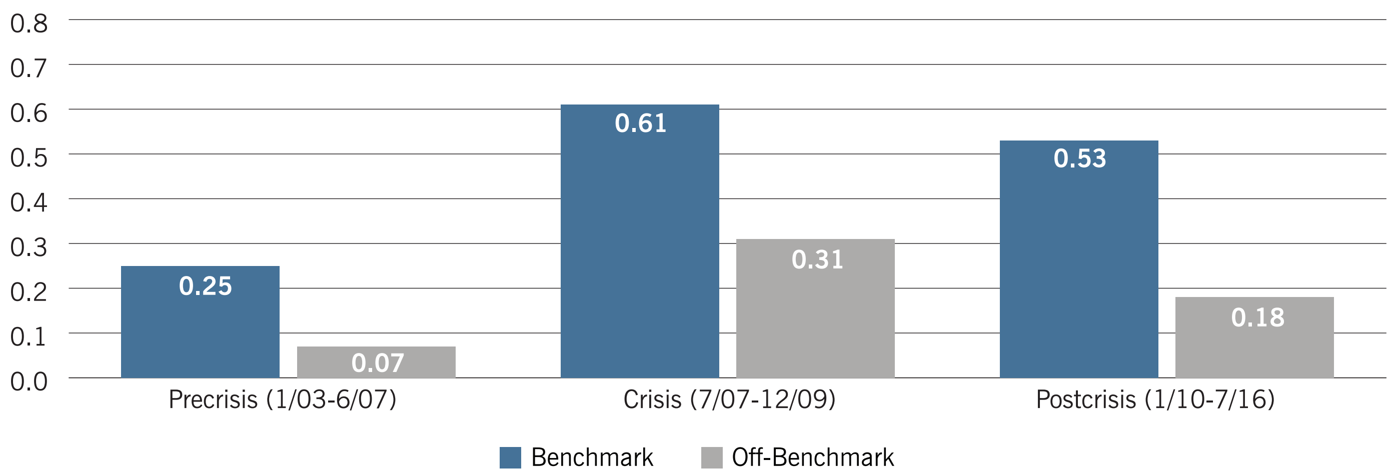
benefits of index-based EM investing have declined over time. Exhibit F shows the correlations between currencies in the popular JPMorgan Government Bond Index-Emerging Markets Global Diversified Index (GBI-EM) to US high yield bonds at various points over the past 15 years, as well as correlations between non-GBI-EM currencies and US high yield bonds over the same period.

The blue bars in the chart represent the 15 currencies in the GBI-EM, which represents local-currency sovereign debt. (We used currencies as proxies for EM debt, to avoid variations in timing of issues, debt volume and maturity among 117 countries examined.) The grey bars are for the 102 countries outside of the GBI-EM.

The blue bar on the left shows that between the GBI-EM's introduction in 2003 and the financial crisis in 2007, index currencies had a correlation of just 0.25 with US high-yield bonds, a common source of yield for US dollar-denominated developed-market fixed income. During the two financial crisis years and afterward, the correlation of GBI-EM currencies to US high yield has risen – undermining the diversification benefits of EM index-based strategies. This change reflects a trend toward index-based portfolios over the past decade, which has been accompanied by large market swings driven by "risk-on" and "risk-off" investor behaviour. Non-index currencies, meanwhile, have largely retained their diversification characteristics. Despite edging up during the crisis, they have since fallen back to 0.18.

In our view, the study does not mean that countries represented by indexes like the GBI-EM cannot offer value at any point in time. What it does point to is the possibility of a better alternative to index-based strategies for investors seeking traditional EM debt exposure.

**Exhibit F** GBI-EM Index currencies have lost diversification power.




Sources: Eaton Vance, Bloomberg LLP, August 2016. Benchmark currencies are represented by the 15 currencies of countries in the GBI-EM. Off-benchmark currencies are represented by 102 countries not contained in EM indexes that have tradeable currencies, as determined by Eaton Vance. Data shown represent the median values for their respective universes. U.S. high-yield bonds are represented by the Bloomberg Barclays US Corporate High Yield Index, which measures USD-denominated, noninvestment-grade corporate securities. Unless otherwise stated, index returns do not reflect the effect of any applicable sales charges, commissions, expenses, taxes or leverage, as applicable. It is not possible to invest directly in an index. Data provided are for informational use only. Past performance is no guarantee of future results.

## The shift to blended allocations

As the EM debt universe has grown in size and diversity, so, too, has awareness among pension funds of the potential benefits of a more diverse and inclusive approach. Increasingly, pension funds have become interested in complementing hard currency sovereign exposures with positions in local currency, corporate and even frontier-market debt. In principle, a broader, more inclusive approach would likely deliver diversification benefits and relatively better risk-adjusted returns over time.

Blended allocations take a number forms. They can, for example, entail allocation at the board level to separately managed individual "sleeves," with each sleeve treated as either a strategic or opportunistic exposure, or delegation to a single investment manager operating within an agreed blended allocation framework. Among large US public pension plans, those that allocate to EM debt (usually below 5% of total plan assets) have sought to incorporate local-currency debt in different ways.[2] Some plans treat it as an opportunistic exposure, some leave currency exposures unhedged as part of their policy on foreign investments, some fully hedge back to US dollars and some will partially hedge subject to an upper US dollar exposure limit for their overall fixed-income portfolio.

## Current blended approaches: a big picture, top-down theme

Notwithstanding the above-mentioned variations, the common feature of most blended approaches currently is their embodiment of a big-picture, top-down allocation approach.

A top-down blended approach, in our view, represents a step forward for investors who want to capture a much broader opportunity set. As Kirstein A/S research shows, a static, equally weighted allocation to the three key subasset classes – hard-currency sovereigns, local-currency sovereigns and hard-currency corporates – has the potential to deliver more than 60% of the return that could be achieved if an investor were able to pick the best-performing subsector in every calendar year.

That said, we believe there are several drawbacks to a purely top-down approach. One is that the allocation is usually reviewed only once a year by the board. In reality, decisions made annually at a board level do not match the speed at which investment conditions and relative valuations change within this asset class. For example, allocation decisions made earlier in 2016 – save in instances where the investment manager had been afforded meaningful discretion – are unlikely to have been revisited immediately following Donald Trump's November election victory, even though his win raises the prospect of a stronger US dollar. Under President-elect Trump, greater deficit spending and protectionist policies may well lead to higher wage growth and inflation, leading to upward pressure on Treasury yields as well as the Federal Reserve to raise US overnight interest rates at a pace faster than had been projected.

Another drawback to blending key EM debt asset classes via a big-picture, top-down approach is that it typically entails a focus on key indexes (i.e., EMBI GD, GBI-EM GD and CEMBI BD) with the result that, even allowing for tactical overweights or underweights, underlying allocations share the limitations inherent in these indexes. Allocation across index-like exposures also raises other issues. Consider the following:

- Country risk factors are major drivers of asset performance, particularly for emerging-market countries.[3] Unfortunately, country representation across the popular indexes varies greatly. For example, India is in the CEMBI, but not the other sovereign and local index. Allocation across asset types impacts country allocations.
- Switching index-like exposures entails a meaningful shift in duration. GBI–EM GD has a duration of around 4.5 years, while EMBI-GD has a duration of around seven years. Switches between external sovereigns and external corporates (assuming index-like exposures) will result in a change in US duration. Few investors are fully aware of the extent of developed-market risk within EM indexes. (A bottom-up risk factor approach, however, would be very mindful of this.)
- When a country (e.g., Russia) is prominent in all three indexes, the absolute level of risk concentration may be greater than optimal in the combined weightings of the three indexes. In the case of Russia, there are often also important relative value distinctions between its local-currency and dollar-denominated debt, and between its sovereign and corporate issues. Such distinctions fall outside the scope of purely top-down asset allocation analysis.

[2]Source: World Bank Treasury Report, Emerging Markets Local Currency Debt and Foreign Investors, November 2014.

A matter of practicality, many pension fund guidelines call for the inclusion of a benchmark. In such cases, where investors want a blended approach, using a blended benchmark of something like 50% GBI-EM, 25% EMBI and 25% CEMBI - which reflects the debt outstanding in the broader universe - could be an option. However, we believe a benchmark should function largely as a reference for portfolio performance rather than an anchor point for portfolio construction. Allocation strategies based principally on overweighting and underweighting common EM indexes are not optimal for investing in this sector.

## The future of blended: Active, unconstrained, risk factor-based

Unconstrained investing offers access to a much broader range of investment opportunities, as shown in Exhibit G.

At Eaton Vance, we prefer an index-unconstrained approach that focuses on country-level macroeconomic and political research across the entire investment opportunity set along with bottom-up analysis of specific risk factors. Bonds are instruments that can be broken down into their component risk factors: currency, interest rates, sovereign credit spreads and corporate/loan credit spreads. Disaggregating and evaluating such idiosyncratic risk factors at the country level is, we believe, an approach that can be a consistent source of alpha. Exhibit H is an example of how analysis of different risk factors can shape portfolio positioning.

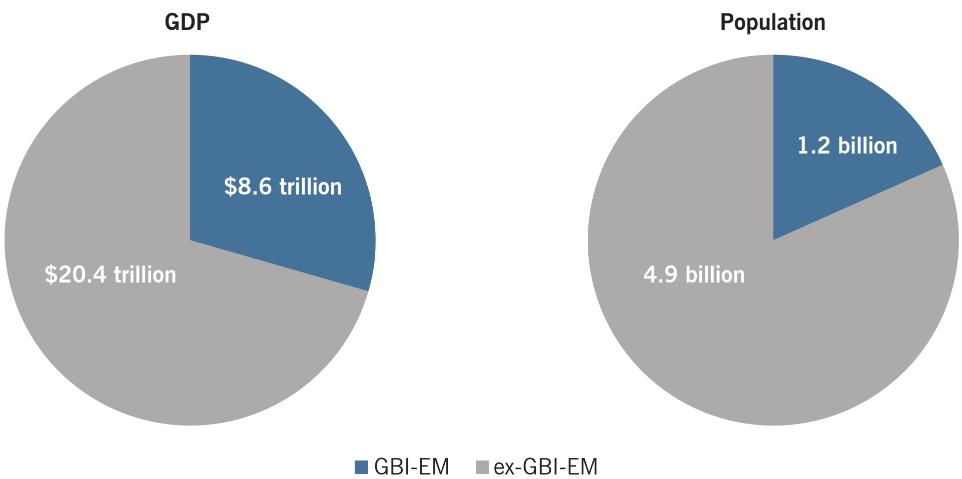
A simplified example of risk factor analysis, incorporating liquidity considerations, is shown in Exhibit I. Note the derivative instrument options available, which allow the investment manager to target exposure to a specific risk factor.

## Challenges for an unconstrained blended approach

Unconstrained investing across different subasset classes of EM debt – an approach involving meaningful exposure to non-index countries – requires extensive investment resources, considerable experience and a strong, dedicated trading capability. The examples that follow seek to illustrate this point.

Mozambique's current debt crisis (as at 11 November 2016) provides a timely example of the importance of extensive country-level research. In late October, Mozambique surprised creditors by admitting its debt levels were unsustainable and that it was seeking restructuring of its entire external commercial debt, including the 2023 sovereign bond that creditors had agreed to restructure only six months previously. More than US$2 billion of previously undisclosed debt came to light and the bonds plunged. Creditors include some high-profile fund management houses, which are now seeking greater clarity from the government about the country's finances. Warning signs earlier in the year had prompted us to warn investors about the high risk of a full-blown restructuring. In the second quarter,

**Exhibit G** EM economic and demographic potential outside of the GBI-EM.




Source: International Monetary Fund, World Economic Outlook Database, October 2016. GDP and population data are for 2015.

[2]Sources: Baldacci, Gupta, & Mati, 2008; Beck, 2001; Eaton Vance, 2015; Heston & Rouwenhorst, 1995; Rowland & Torres, 2004; Serra, 2000; Stocker, in press.

**Exhibit H** Relative value among various risk factors.
Country-specific outlook: Russia (October 2016)

| | Underweight | Slight Underweight | Neutral | Slight Overweight | Overweight |
|---|---|---|---|---|---|
| **Currency** | | | | ● | |
| **Local Interest Rates** | | | | | ● |
| **Sovereign Credit** | | ● | | | |
| **Corporate Credit** | ● | | | | |

Source: Eaton Vance Management as at 31 October 2016. This outlook is provided for informational use only. It should not be considered investment advice.

Mozambique defaulted on a principal payment on a secretly arranged loan carrying a sovereign guarantee, citing a weakened currency and depleted reserves as the reason for nonpayment.

For EM debt bond holders, this crisis has added significance because the IMF has stated, following a 2013 review of debt restructurings, that the Fund should avoid "the use of Fund resources to simply bail out private creditors." Mozambique's crisis poses a test for the IMF's protocol for assisting struggling countries. If the IMF does take a tougher line on future restructurings, the value to investors of conducting robust, in-depth country analysis may become even more apparent.

Trading EM debt can be very challenging. Regulations relating to market access, taxation and trading restrictions change frequently. An investment manager that does not have a well-resourced trading capability focused full-time on these countries can end up losing money. Such a manager can end up with money "stuck" in countries like India or Nigeria, suffer poor FX rates on "restricted currencies" left with a custodian to trade or find themselves paying taxes that could be avoided. These losses can easily exceed the circa 40-70 basis points paid to a suitably skilled third-party investment manager.

One example of a country where investors have recently suffered losses relating to trading difficulties is Nigeria. Africa's biggest economy, which was admitted to the widely tracked GBI-EM Index in 2012 after removing a requirement that foreign investors hold government bonds for a minimum of one year before exiting, was last

**Exhibit I** Risk factor analysis – a simplified overview.

| | Currency | Interest Rates | Sovereign Credit Spreads | Corporate/Loan Credit Spreads |
|---|---|---|---|---|
| **Risk Factor Pricing Analysis** | ▪ Real effective exchange rate<br>▪ IR differentials | ▪ Nominal rates<br>▪ Real rates<br>▪ IR differentials<br>▪ Term structure | ▪ Default probability<br>▪ Historical spreads<br>▪ Absolute spreads<br>▪ Relative spreads | ▪ Spread premium to sovereign |
| **Instrument Options** | ▪ Currency forwards<br>▪ Currency options<br>▪ Local bills<br>▪ Local deposits<br>▪ Money markets | ▪ Local sovereign bonds<br>▪ Inflation-linked sovereign bonds<br>▪ Interest-rate swaps<br>▪ Futures | ▪ External sovereign bonds<br>▪ Credit default swaps | ▪ Local currency<br>▪ External<br>▪ Convertibles |

**Liquidity**
(% of issue; % of trading volume; market segmentation; market positioning)

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year notified by JP Morgan that it would be removed from the index due to expanded restrictions on currency trading. Foreign currency restrictions – introduced amid an oil price-related economic crisis and dwindling US dollar reserves – made it more difficult for foreign investors to trade naira bonds and adversely impacted their ability to repatriate capital. Although the country has now devalued its currency, some investors suffered losses by not being able to repatriate monies ahead of anticipated currency devaluations.

A further complication in operating locally in a country like Nigeria is the sheer amount of documentation involved. In order to get money into or out of Nigeria, an investor needs a document known as a Certificate of Capital Importation (CCI) and needs to be able to reconcile every trade with the CCI statement showing how much was brought into the country. An "Authorised Dealer" – a Nigerian bank licensed by the Central Bank of Nigeria (CBN) to deal in foreign exchange – issues the CCI and has responsibility to track payments to ensure that they are linked to the initial investment. However, because investors are not required to repatriate the proceeds when they exit one investment and enter another, tracking these payments is difficult. Investors aware of potential CCI-related difficulties can proactively seek to ensure their CCIs are fully up to date at all times; however, from our perspective, few investors make the effort to do so.

In view of the many complexities that come with investing in EM debt, Eaton Vance employs six EM debt traders in Boston, London and Singapore and five trading assistants. This capability, in our view, is absolutely necessary. Aside from helping us to stay on top of changing regulations, it puts us in a position – unlike that of many peers – of being able to trade our own FX. The advantage of this is that we avoid the risk of expensive FX trades that can arise when trades are left in the hands of a custodian. Our trading capability also allows us to structure trades advantageously and affords us investment flexibility. For example:

- In Colombia, we put our trades on a payment system that avoids transaction taxes; and
- In Thailand, our traders are skilled at navigating the restrictive FX account system to ensure maximum investment flexibility. (Each type of account restricts the use of funds in the account and currency cannot be moved between accounts).

## Other considerations

Investors considering moving to internal management of their EM debt allocation ought to be aware that the pool of EM debt trading expertise is relatively small. Being able to attract sufficient trading talent dedicated to a particular pension fund may prove to be a challenge. Internal management also potentially raises governance challenges around transparency and investment performance.

Traditional approaches to management of local-currency debt have, to date, disappointed a number of investors. Matching or surpassing the performance of the local currency indexes has proved difficult, particularly in up markets. The JPMorgan GBI-EM Global Diversified Index is a gross index: It doesn't reflect the drag on returns of taxes paid by real-world investors who want to track its performance. These taxes will be different for different investors depending on factors such as how the fund is structured, which instruments are used to execute a trade and where the fund is domiciled. Investors might want to re-evaluate the cost benefit of how they have traditionally approached local-currency debt versus an "optimised" unconstrained approach.

## Can an unconstrained, blended approach deliver added value?

Clearly, pension funds will need to do their own due diligence on this question. That said, we believe Eaton Vance's track record in blended unconstrained mandates points to the viability of such an approach. Our Emerging-market debt Opportunities Strategy, which has been running for more than three years, has been able to generate alpha and excess return with lower-than-benchmark volatility. This track record builds on more than a decade of experience in sourcing and implementing investments in nearly 100 local markets and has been achieved with the help of clients who have allowed us the flexibility to allocate across the entire opportunity set. Indicative of this flexibility, the strategy had, as at 30 September 2016, more than 50% of its assets in off-benchmark instruments.

## Conclusion

EM debt offers a unique source of income and, for portfolios comprising mainly developed-market fixed income, diversification. However, successful investment in this complex asset class requires specialist expertise and a keen awareness of its many idiosyncrasies and potential pitfalls. This is particularly true for investors seeking to move to a blended approach.

At Eaton Vance, we believe a blended, index-based approach represents a defensive, straightforward option that boards may find reasonably easy to approve and oversee. Nonetheless, the inherent flaws in indexes point to the potential advantage of a more sophisticated, active approach: one seeking to evaluate risk factors in each country across the entire tradable universe. For investors, adopting such an approach requires a new mindset and becoming comfortable with a portfolio exhibiting a substantial tracking error to a performance benchmark. It presupposes extensive due diligence, but also recognition of how much money traditional approaches currently leave "on the table."

**Henrik Hoffmann-Fischer**
Co-Head of Intelligence
Kirstein A/S

Henrik Hoffmann-Fischer is Co-Head of Intelligence at Kirstein A/S. Henrik is responsible for consulting asset managers on investment trends, strategies and changes among institutional investors in Continental Europe. Henrik joined Kirstein A/S in 2009 as an investment consultant.

Henrik holds an M.Sc. in political science and was educated at the School of Foreign Service, Georgetown University, Washington, DC and at the University of Copenhagen.

**Sebastian Vargas, CFA**
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## Index Definitions

**The JP Morgan Emerging Markets Bond Index Global Diversified (EMBI GD)** is a broad index of hard currency sovereign bonds issued by a selection of emerging market countries. Like the EMBI Global Index, it includes US dollar denominated Brady bonds, Eurobonds, traded loans and local market debt instruments issued by sovereign and quasi-sovereign entities. However, it differs from EMBI Global in that it limits the weights of countries with larger debt stocks.

**The JP Morgan Government Bond Index-Emerging Markets Global Diversified Index (GBI-EM GD)** is an unmanaged index of local-currency bonds with maturities of more than one year issued by emerging markets governments. Like the GBI-EM Global Index, it includes only those countries that are directly accessible by most of the international investor base. Unlike GBI-EM Global, GBI-EM Global Diversified limits the weights of index countries with larger debt stocks.

**The JP Morgan Corporate Emerging Markets Bond Index Broad Diversified (CEMBI BD)** is a market capitalisation weighted index that tracks hard currency (US$–denominated) corporate bonds issued by emerging markets entities.

**The JP Morgan Emerging Markets Bond Index Plus (EMBI+) Index** is a market-cap weighted index that measures US dollar-denominated Brady Bonds, Eurobonds and traded loans issued by sovereign entities.

## About Risk

Investments in non-US instruments or currencies can involve greater risk and volatility than US investments ecause of adverse market, economic, political, regulatory, geopolitical or other conditions. In emerging countries, these risks may be more significant. Investments in income securities may be affected by changes in the creditworthiness of the issuer and are subject to the risk of nonpayment of principal and interest. The value of income securities also may decline because of real or perceived concerns about the issuer's ability to make principal and interest payments. Derivative instruments can be used to take both long and short positions, be highly volatile, result in economic leverage (which can magnify losses), and involve risks in addition to the risks of the underlying instrument on which the derivative is based, such as counterparty, correlation and liquidity risk. If a counterparty is unable to honour its commitments, the value of the portfolio may decline and/or the portfolio could experience delays in the return of collateral or other assets held by the counterparty. The value of commodities investments will generally be affected by overall market movements and factors specific to a particular industry or commodity, including weather, embargoes, tariffs, or health, political, international and regulatory developments. As interest rates rise, the value of certain income investments is likely to decline. Due to the fact that a portfolio may invest significantly in a particular geographic region or country, value of the portfolio may fluctuate more than a portfolio with less exposure to such areas. Investments rated below investment grade (typically referred to as "junk") are generally subject to greater price volatility and illiquidity than higher-rated investments. A nondiversified portfolio may be subject to greater risk by investing in a smaller number of investments than a diversified portfolio.

## About Eaton Vance

The Eaton Vance Group is a leading global asset manager whose history dates to 1924. With offices in North America, Europe, Asia and Australia, Eaton Vance and its affiliates offer individuals and institutions a broad array of investment strategies and wealth management solutions. Eaton Vance's long record of providing exemplary service, timely innovation and attractive returns through a variety of market conditions has made Eaton Vance the investment manager of choice for many of today's most discerning investors. For more information about Eaton Vance, visit eatonvance.com.

## About EVMI

Eaton Vance Management (International) Limited ("EVMI") is a subsidiary of Eaton Vance Management ("EVM"), a leading U.S. asset management organisation, and markets internationally the investment capabilities of Eaton Vance Management and its affiliates, including Parametric Portfolio Associates LLC (Parametric). EVMI has been based in London since 2001.


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