For Higher Yield, Consider Emerging Market Debt

By Peter Marber *Tue, Mar 9, 2021*

investors will find that a blend of EM dollar bonds from dozens of countries can help diversify their portfolios and improve their outcomes, writes our guest columnist, head of emerging markets at Aperture Investors LLC in New York.

Historically, bonds have been essential to diversified portfolios—for both individual and institutional investors. Steady bond income reduces volatility and preserves capital to balance the risk of stocks, particularly during bouts of market stress. Bond coupons also provide liquidity for making incremental portfolio changes without the cost of selling assets.

But US investors, as well as those in Europe and Japan, have seen both government and corporate bonds yields collapse in both relative and absolute terms in the last dozen years. Zero Interest Rate Policy (ZIRP), Quantitative Easing (QE), and Negative Interest Rate Policy (NIRP) have left investors with slim pickings in the bond space.

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These central bank policy tools have become more common since the Global Financial Crisis in 2008. They helped push rates lower during the pandemic-induced economic contraction last year. In December 2020, Bloomberg reported that 27% of the world's investment grade debt was yielding below *zero*. Rates are so low that investors can no longer consider global government bonds "risk free;" some call them "return free risk."

Indeed, the recent backup in 10-year US government bond rates (from a low of 0.51% in August 2020 to 1.40% in February 2021) cost investors more than 8% in capital losses. Longer-dated US Treasuries sank even more during this period.

While rates have rebounded from their summer 2020 lows, bonds worldwide still suffer from a yield shortage. To make up for this loss, many investors have (1) extended duration to pick-up additional return; (2) flocked to lesser liquid alternatives such as bank loans and private credit; or (3) switched to stocks. In total, these strategies are forcing investors to assume considerably more portfolio risk than they would with traditional bonds. Academics say that's how finance works: the Capital Asset Pricing Model says investors need to take more risk to get more return. But maybe practice tops theory.

One exception worth exploring is the US dollar-denominated bond space of Emerging Market (EM) issuers in Asia, Latin America, the MidEast, Africa, and the former Soviet Union. This $3.7 trillion universe (roughly twice the US high yield market) includes more than 3,000 different bonds from more than 75 countries with credit ratings from AAA down to CCC. They offer higher yields than comparable American corporate bonds, on average, and help diversify a traditional US bond portfolio. A pool of bonds from dozens of economies helps reduce country risk. Like global equity portfolios, some Emerging Markets zig when others zag; that reduces overall portfolio risk.

More Than Meets the Eye

As Figure 1 shows, EM credit offers considerably more yield than US corporate bonds with comparable ratings:

Rating	US YTW (%)	EM YTW Corp (%)	US Spread (bps)	EM Spread Corp (bps)	Excess Premium in EM (%)	US Duration (yrs)	EM Duration (yrs)
AA	1.4	**1.7**	58	**93**	60	**9.6**	5.8
A	1.5	**2.2**	78	**134**	72	8.7	5.9
BBB	2.1	**2.8**	120	**196**	63	8.6	5.6
BB	3.8	**3.9**	264	**328**	24	4.3	3.9
B	5.4	**5.7**	381	**543**	43	2.6	2.6
CCC	8.3	**11.7**	627	**1136**	81	2.2	2.3

The risk premium offered by EM dollar-bonds has fluctuated but generally offers greater yields, and often with shorter durations. Most investors assume that they will have to take on higher default risk to get that extra return, but EM dollar-bonds have actually defaulted *less* than US equivalents. According to JP Morgan, the average annual default rate from 2008 through 2020 was 3.56% for US bonds but only 3.38% for EM bonds.

This may represent a missed opportunity. EM bonds have generated higher returns in US-dollar terms than their US equivalents, and could have offered even more return for modest increases in risk (see Figure 2) when blended with a traditional US bond portfolio.

Allocation	Total Return	Ann. Vol	Ann. Return
100% US Bonds	55.29%	2.92%	4.08%
90% US/10% EM	59.74%	2.97%	4.35%
80% US/20% EM	64.26%	3.14%	4.61%
70% US/30% EM	68.83%	3.40%	4.88%
60% US/40% EM	73.46%	3.74%	5.13%
50% US/50% EM	78.15%	4.14%	5.39%
100% EM Bonds	102.31%	6.60%	6.61%

Source: for US bonds, Bloomberg Barclays Aggregate Total Return Index; for EM bonds, a 50/50 blend of JPM Morgan's EMBI and CEMBI indices.

Why haven't more investors embraced EM dollar bonds? Maybe they misperceive the nature of an "emerging market." The term, coined by the World Bank in 1989, is tied to a country's per capita national income figures. The current threshold is $12,536 or less.

Oddly, dozens of EM countries have income above this threshold yet they are arbitrarily included in many EM investment indices. Several benchmarks lump South Korea, the world's ninth largest economy with a per capita income level of nearly $32,000, with countries where annual income is less than $5,000. Many EMs also have better credit ratings than developed countries. Poland has higher ratings than Italy, South Korea than Japan, and Chile than Portugal. Singapore, which can be found in several EM indices, is among the ten AAA-rated countries in the world.

Investors' misperceptions of EM countries may also be anchored by memories of crises in Mexico, Asia, and Russia during the 1990s. But EMs demand a reappraisal. Many, including China and India, are among the most dynamic and fastest-growing economies in the world. And the EM universe's default and return statistics clearly show that the sector performs better than most investors imagine.

Still growing, still attractive

The EM bond universe is broadening and deepening, with more than $500 billion new issues last year. In January 2021 alone, more than $100 billion of EM dollar-bonds were floated from governments and corporations. Their yields still look attractive:

Segment	Average Yields
EM Sovereign Investment Grade	3.29% (156 bps above US Treasuries)
EM Sovereign High Yield	7.42% (613 bps above US Treasuries)
EM Corporate Investment Grade	3.05% (176 bps above US Treasuries)
EM Corporate High Yield	5.94% (465 bps above US Treasuries)

Source: JP Morgan, February 26, 2020

While institutional investors typically build diversified portfolios of EM bonds from scratch, individuals can get tailored exposure from mutual funds and ETFs. Either way, investors can choose investment grade or high yield, specific regions, and a range of maturities. Given the large coupons earned annually from such bonds, individual investors might consider adding them to tax-deferred retirement accounts to optimize their long-term compounded returns.

Investors don't need to shoulder additional credit, duration, liquidity, or equity risk when seeking substitutes for traditional low-yielding US government and corporate debt. Armed with new data and a fresh perspective, investors will find that a blend of EM dollar bonds from dozens of countries can help diversify their portfolios and improve their outcomes.

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