



Access the opportunities.

More than zero:

Using emerging markets bonds
to optimise portfolios

November 2020

There are a number of reasons many investors do not yet have emerging markets (EM) bonds in their portfolio, including awareness, understanding and difficulty of access. All of this means investors are potentially missing out on the diversification and yield benefits associated with EM bond investing.

In a previous paper we described EM bonds as “the missing asset class”, arguing that investors should consider allocating to EM bonds as either part of an allocation to global bonds or as a standalone asset class. The purpose of this paper is to go a step further and highlight how an allocation to EM bonds can enhance a diversified portfolio.

EM bonds are, as the name suggests, bonds issued in and by emerging markets. Despite emerging markets representing over 50% of global GDP, the level of EM bond issuance and investment is nowhere near what would be implied by their potential contribution to global growth.

During the COVID-19 crisis many emerging markets were able to navigate the catastrophe without having to resort to the unconventional policies pursued by central banks and governments in developed markets. Furthermore, many developed markets’ policies during the COVID-19 crisis benefited emerging markets as global stimulus made its way into EM bonds, just as it did post-GFC.

Now, with Australian and developed market (DM) bond yields extremely low, the higher yields available on EM bonds provide investors with the potential for higher income with commensurate risk.

By analysing the historical risk and returns of asset classes including EM bonds, as well as analysing EM bonds contribution to fixed income and diversified portfolios, we find that EM bonds can improve the returns of diversified portfolios that use them as part of a fixed income allocation. Further we find that EM bonds improve the risk-adjusted returns of diversified portfolios that treat EM bonds as a separate asset class like they do alternative assets.

On a forward looking basis too, EM bonds warrant an allocation.

EM bonds have the potential to enhance a diversified portfolio’s risk-return properties and income.

Irrespective of whether you consider EM bonds as part of a global fixed income allocation or you treat them as a separate asset class, the data shows your allocation should be more than zero.

Welcome to the new world in which EM bonds should be a consideration for all investors.

EM bonds

The universe of EM bonds consists of four main components, each with its own unique characteristics.

Hard currency sovereign bonds

This is debt issued by governments in hard currencies, usually US dollars. The yield is typically higher than US treasuries to compensate for the additional risk of investing in emerging markets.

Local currency sovereign bonds

This is debt issued by governments in their own currency. This is the largest segment of EM bonds so it is the most liquid. Investors can also take advantage of the returns from currency movements.

Hard currency corporate bonds

This is debt issued by companies within emerging markets in hard currencies, usually US dollars. There are many issuers which allows for diversification by sector, country and security.

Local currency corporate bonds

This is debt issued by companies within emerging markets in their own currency.

The old world

Two decades ago, in the “old world”, EM bonds were risky and volatile due to low reserves and the limited ability to absorb losses. This was typified by the 1997 “Asian financial crisis” and the 1998 Russian debt crisis.

The Asian financial crisis began in 1997. Thailand’s currency devalued as foreign investors withdrew, concerned the country was bankrupt. With no reserves, Thailand’s government could do little. The crisis spread throughout the region and those hardest hit were the ones with low domestic reserves. Finally the IMF stepped in to stabilise the Korean, Thai and Indonesian economies.

This crisis was closely followed by the similar Russian currency crisis and Argentina’s much publicised default in 2001.

These crises set the scene for significant economic reforms through the early part of the new millennium in many emerging markets. Governments were forced, often for the first time, to be fully transparent with foreign investors and global monetary funds in order to obtain financial rescue packages.

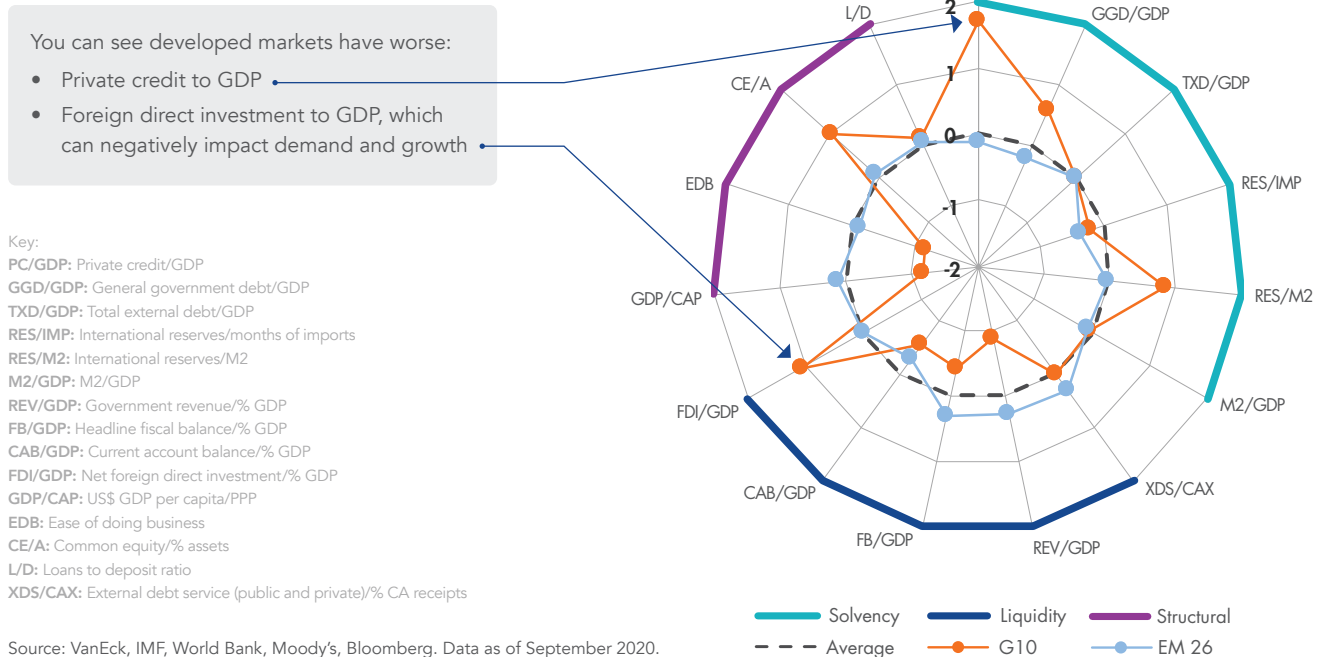
The new world

As a result of the reforms many emerging market economies came out of the GFC structurally stronger than their developed market counterparts. Many emerging market governments were able to better implement counter-cyclical fiscal expansion to reignite growth because of their growing foreign exchange reserves, strong budgets and robust balance of payments.

During the COVID-19 crisis many emerging markets handled the economic fallout with aplomb. Ukraine, Poland and Romania are but a few examples.

Global comparisons show that emerging market economies are as liquid and structurally sound as developed markets. Emerging markets generally have stronger balance sheets. Looking at Figure 1 on the next page, on the radar chart, the red line is the global mean. The circles represent standard deviations above and below the mean. The further you are away from the centre, the worse it is.

Figure 1: Macroeconomic radar: EM and DM



The “new world” in emerging markets is characterised by higher reserves and lower spreads on bonds. Current accounts and government budgets are largely in check. Policy makers, appealing to an ever growing and better educated middle class encourage savings and pension reforms driving capital investment. Some of the best managed economies are in emerging markets.

Despite their stronger fundamentals, emerging market governments and corporations generally pay more than their developed market counterparts when they issue bonds. This is an opportunity for investors to look beyond the past.

The question is how to allocate. Should investors consider EM bonds as part of a global bond allocation, or should it be considered as a standalone asset class within the context of a diversified fund. Both, we find, are right.

The “new world” in emerging markets is characterised by higher reserves and lower spreads on bonds.

Portfolios have been under allocated to EM bonds

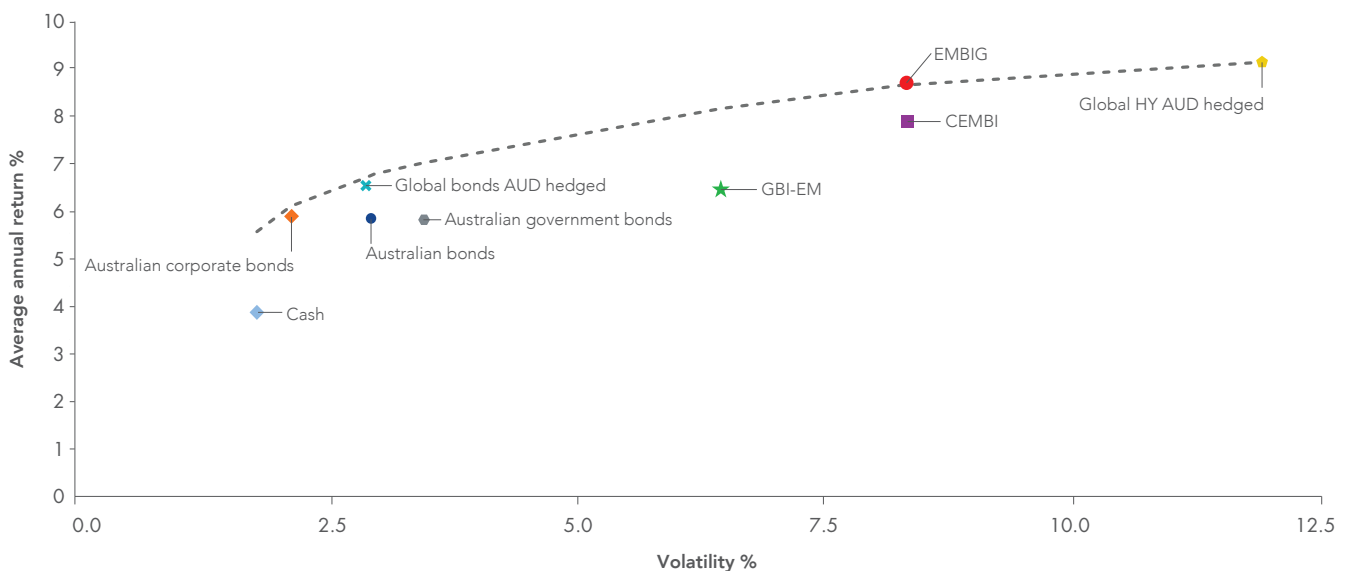
A commonly-used framework for asset allocation decisions is the efficient frontier, which shows the optimal portfolio that offers the highest expected return for a given level of risk.

By analysing historical returns for the period January 2004 to September 2020, it is possible to determine if you could have reduced volatility without sacrificing return, or boosted return without increasing volatility by adjusting the mix of asset classes.

In the following charts, we input the historical returns and volatility of key asset classes. The efficient frontier line represents the optimal combination of these asset classes such that no other combination can increase return without a rise in volatility, nor reduce volatility without a decrease in return. To make this exercise as "pure" as possible, we intentionally chose not to impose any constraints on the individual asset class weights. For example, a maximum allocation of 5% or 10% to smaller asset classes is a common rule-of-thumb that many institutions use.

First we compare EM bonds to the fixed income universe Australian investors typically allocate to. It is common for allocation between these sectors to be carried out by a single manager in the case of diversified fixed income funds. Australian investors may also have separate managers to manage each of these asset classes. Our selection is, of course, not exhaustive.

Figure 2: Efficient frontier global fixed income portfolio (January 2004 to September 2020)



Source: Bloomberg, VanEck, January 2004 is the common inception date. Results are calculated monthly and assume immediate reinvestment of all dividends. You cannot invest in an index. Past performance is not a reliable indicator of future performance. Volatility is Standard Deviation of returns. Indices used: **Cash** – Bloomberg Australian Bank Bill 0+ Yr Index; **Australian Corporate Bonds** – Bloomberg AusBond Corporate 0+ Yr Index; **Australian bonds** – Bloomberg AusBond Composite 0+ Yr Index; **Global Bonds AUD** – Barclays Global Aggregate Bond Index A\$ Hedged; **Australian Government Bonds** – Bloomberg AusBond Govt 0+ Yr Index; **GBI-EM** – J.P. Morgan Government Bond Index-Emerging Markets Global Diversified (GBI-EM); **EMBIG** – J.P. Morgan Emerging Markets Bond Index Global Diversified (EMBIGD) – EMBIGD is unhedged, EMBND hedges its hard currency; **CEMBI** – J.P. Morgan Corporate Emerging Markets Bond Index (CEMBI); **Global HY AUD hedged** – Bloomberg Barclay Global High Yield Index A\$ Hedged.

Figure 3: Global fixed income portfolio's efficient frontier and implied weight**Data set – monthly, 2004 to 2020 (Jan–Sept)**

	← Low risk						High risk →		
Portfolio standard deviation	1.83	2.18	2.93	3.02	3.49	6.50	8.35	8.41	11.91
GBI-EM	1%	5%	17%	18%	22%	24%	1%	0%	0%
EMBIG	0%	0%	0%	0%	9%	75%	99%	100%	0%
CEMBI	0%	0%	0%	0%	0%	0%	0%	0%	0%
Cash	24%	4%	0%	0%	0%	0%	0%	0%	0%
Australian bonds	0%	0%	0%	0%	0%	0%	0%	0%	0%
Australian corporate bonds	66%	71%	15%	9%	0%	0%	0%	0%	0%
Australian government bonds	0%	0%	0%	0%	0%	0%	0%	0%	0%
Global bonds AUD hedged	3%	15%	55%	59%	56%	0%	0%	0%	0%
Global HY AUD hedged	4%	5%	13%	13%	13%	2%	0%	0%	100%
EM FI (GBI-EM, EMBIG, CEMBI)	1%	5%	17%	18%	31%	98%	100%	100%	0%

Source: Bloomberg, VanEck, Results are calculated monthly and assume immediate reinvestment of all dividends. You cannot invest in an index. Past performance is not a reliable indicator of future performance. Portfolio standard deviations measure volatility. Indices used: **GBI-EM** – J.P. Morgan Government Bond Index-Emerging Markets Global Diversified (GBI-EM); **EMBIG** – J.P. Morgan Emerging Markets Bond Index Global Diversified (EMBIGD) – EMBIGD is unhedged, EMBIG hedges its hard currency; **CEMBI** – J.P. Morgan Corporate Emerging Markets Bond Index (CEMBI); **Cash** – Bloomberg Australian Bank Bill 0+ Yr Index; **Australian bonds** – Bloomberg AusBond Composite 0+ Yr Index; **Australian Corporate Bonds** – Bloomberg AusBond Corporate 0+ Yr Index; **Australian Government Bonds** – Bloomberg AusBond Govt 0+ Yr Index; **Global Bonds AUD** – Barclays Global Aggregate Bond Index A\$ Hedged; **Global HY AUD hedged** – Bloomberg Barclay Global High Yield Index A\$ Hedged.

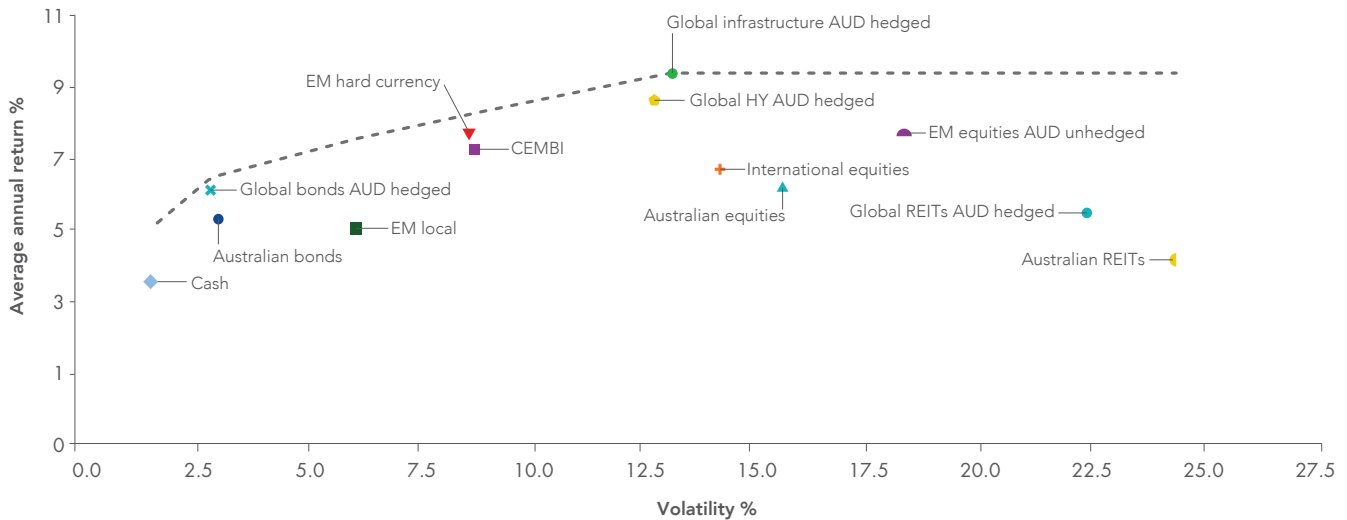
The main takeaway is that if your allocation to fixed income does not include EM bonds, then it appears you have been under-represented. For a moderate risk global fixed income portfolio of, say, 5% to 9% volatility level shown on the x-axis in Figure 2 – an efficient frontier analysis (presented in Figure 3) suggests that the majority of a fixed income portfolio should be invested in EM hard currency bonds. Furthermore, an efficient frontier analysis argues for a sizable EM bonds allocation of up to 18%, even for a low volatility portfolio of 3%. Australian corporate bonds, by contrast, has only 9% at the same volatility.

Interestingly, this analysis suggests that high yield and EM bonds should be used together, not as a “substitute” for each other.

A look at Figure 2 shows that high yield generated double the volatility of the EMBIG with almost no increase in expected return.

In the current low interest rate world, investors are looking beyond bonds for yield. Within this context then, it is worthwhile assessing if bonds can play a role in portfolios the way alternative assets, high yield bonds or equities can. In Figure 4 below we expand our efficient frontier analysis to consider asset classes most investors consider to build diversified conservative, balanced and growth portfolios.

Figure 4: Efficient Frontier – global asset portfolios (January 2006 to September 2020)



Source: Bloomberg, VanEck, January 2006 is the common inception date. Results are calculated monthly and assume immediate reinvestment of all dividends. You cannot invest in an index. Past performance is not a reliable indicator of future performance. Indices used: **Cash** – Bloomberg Australian Bank Bill 0+ Yr Index; **Australian Bonds** – Bloomberg AusBond Composite Index 0+ Yr Index; **Global Bonds AUD** – Barclays Global Aggregate Bond Index A\$ Hedged; **EM local** – J.P. Morgan Government Bond Index-Emerging Markets Global Diversified (GBI-EM); **EM hard currency** – J.P. Morgan Emerging Markets Bond Index Global Diversified (EMBIGD) – EMBIGD is unhedged, EMBND hedges its hard currency; **CEMBI** – J.P. Morgan Corporate Emerging Markets Bond Index; **Global HY AUD hedged** – Bloomberg Barclay Global High Yield Index A\$ Hedged; **Global Infrastructure** – FTSE Developed Core Infrastructure 50/50 Hedged into Australian Dollars Index; **International equities** – MSCI World ex Australia Index, Australian equities – S&P/ASX 200; **EM equities** – MSCI Emerging Markets Index; **Global REITs** – FTSE EPRA Nareit Developed AUD Hedged, **Australian REITs** – S&P/ASX 200 A-REITs Index.

Figure 5: Global fixed income portfolio's efficient frontier and implied weight

Data set – monthly, 2006–2020 (Jan–Sept)

	← Low risk						High risk →					
Portfolio standard deviation	1.82	2.97	3.19	6.24	8.66	8.80	12.66	14.20	15.58	18.25	24.19	
Cash	26%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	
Australian bonds	13%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	
Global bonds AUD hedged	50%	84%	83%	52%	24%	22%	0%	0%	0%	0%	0%	
EM hard currency	0%	0%	0%	7%	22%	23%	4%	0%	0%	0%	0%	
EM local	1%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	
International equities	9%	7%	5%	0%	0%	0%	0%	0%	0%	0%	0%	
Australian equities	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	
Australian REITs	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	
CEMBI	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	
EM equities AUD unhedged	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	
Global REITs AUD hedged	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	
Global infrastructure AUD hedged	0%	9%	12%	41%	55%	55%	92%	100%	100%	100%	100%	
Global HY AUD hedged	0%	0%	0%	0%	0%	0%	4%	0%	0%	0%	0%	
EM FI (GBI-EM, EMBIG, CEMBI)	1%	0%	0%	7%	22%	23%	4%	0%	0%	0%	0%	

Source: Bloomberg, VanEck. Results are calculated monthly and assume immediate reinvestment of all dividends. You cannot invest in an index. Past performance is not a reliable indicator of future performance. Portfolio standard deviations measure volatility. Indices used: **Cash** – Bloomberg Australian Bank Bill 0+ Yr Index; **Australian Bonds** – Bloomberg AusBond Composite Index 0+ Yr Index; **Global Bonds AUD** – Barclays Global Aggregate Bond Index A\$ Hedged; **EM local** – J.P. Morgan Government Bond Index-Emerging Markets Global Diversified (GBI-EM); **EM hard currency** – J.P. Morgan Emerging Markets Bond Index Global Diversified (EMBIGD) – EMBIGD is unhedged, EMBND hedges its hard currency; **CEMBI** – J.P. Morgan Corporate Emerging Markets Bond Index; **Global HY AUD hedged** – Bloomberg Barclay Global High Yield Index A\$ Hedged; **Global Infrastructure** – FTSE Developed Core Infrastructure 50/50 Hedged into Australian Dollars Index; **International equities** – MSCI World ex Australia Index, Australian equities – S&P/ASX 200; **EM equities** – MSCI Emerging Markets Index; **Global REITs** – FTSE EPRA Nareit Developed AUD Hedged; **Australian REITs** – S&P/ASX 200 A-REITs Index.

The analysis again suggests that there are compelling reasons for having meaningful exposure to EM bonds within a diversified portfolio. For a moderate risk portfolio of, say around the 6% to 10% volatility level on the x-axis in Figure 4, an efficient frontier analysis (shown in Figure 5), would suggest an allocation of 7% to 23% to EM bonds.

While we would never advocate the suggested asset allocations suggested by the efficient frontier, 100% allocation to single asset class would be unwise, it does provide a useful theoretical tool to help investors understand where they could be missing out.

EM bonds is one of those asset classes. The analysis shows you should have more than zero in a fixed income portfolio. The question is how to allocate.

Figure 3 and 5 suggests that the maximum allocation for EM bonds should be at around the 6 to 10 volatility level.

It is within this volatility range that many conservative, balanced and growth portfolios are constructed. It is therefore worthwhile to compare diversified portfolios that include EM bonds and those which do not. Further the comparison should also consider portfolios that include EM bonds as part of a global bond allocation and portfolios that consider EM bonds as its own asset class.

Using EM bonds in diversified portfolios

Many investors diversify across asset classes when constructing their portfolios to achieve a future need. An informed understanding of the risk and return of the various asset classes is important to the portfolio construction process.

The Australian Government, via its moneysmart.gov.au website, has provided investors with a practical guide to investing. The website highlights typical investment portfolios including 'conservative', 'balanced' and 'growth' mixes. However the 'moneysmart' portfolios are broken down simply by 'defensive' and 'growth' components and do not go into detailed allocations per asset class.

APRA, in its 2019 My Super Information Paper, provides an example of a balanced fund with a split between defensive and growth that closely matches the moneysmart.gov.au balanced portfolio. APRA's MySuper balanced fund example provides detailed asset class allocations as well as benchmarks for each asset class.

We have used the APRA portfolio and benchmark information to create a 'Balanced A' portfolio for our analysis. This is the baseline balanced portfolio. From that baseline we have created baseline 'Conservative A' and 'Growth A' portfolios based on the moneysmart defensive/growth splits. These baseline portfolios do not include any allocation to emerging markets bonds.

For investors considering emerging markets bonds as a part of a defensive global fixed income allocation, we created a corresponding set of 'B' portfolios which increase the allocation within global fixed income to EM bonds from zero to 25%. These portfolios are 'Conservative B', 'Balanced B' and 'Growth B' in our analysis.

For investors that consider EM bonds as a separate asset class, we have created another set of 'C' portfolios which follow APRA's lead and treat EM bonds as a separate asset class divided equally between growth and defensive allocations. In our analysis these portfolios are 'Conservative C', 'Balanced C' and 'Growth C'.

The asset allocations and APRA indices used to build the A, B and C portfolio sets, are outlined in the Appendix.

Figures 6, 7 and 8 show the returns, volatility and Sharpe ratios of these hypothetical portfolios.

Figure 6: Performance of different diversified portfolios

	YTD (%)	1 Year (%)	3 Years (% p.a.)	5 Years (% p.a.)	7 Years (% p.a.)	Common inception (% p.a.)
Conservative A	0.53	0.93	5.41	5.56	6.08	6.26
Conservative B	-0.23	0.17	5.44	5.61	6.21	6.40
Conservative C	0.38	0.63	5.32	5.43	6.00	6.14
Balanced A	-3.41	-1.48	6.34	7.47	7.95	8.60
Balanced B	-3.69	-1.77	6.35	7.48	8.00	8.64
Balanced C	-3.65	-1.87	6.27	7.35	7.90	8.50
Growth A	-4.87	-2.50	6.62	8.15	8.63	9.43
Growth B	-5.06	-2.70	6.62	8.16	8.66	9.46
Growth C	-5.16	-2.94	6.55	8.01	8.60	9.36

Source: Morningstar Direct, VanEck. Common inception date is 1 January 2013. Results are calculated monthly and assume immediate reinvestment of all dividends and exclude all fees and costs of investing. You cannot invest in an index. Past performance is not a reliable indicator of future performance. See the Appendix for asset allocation and indices used.

Figure 7: Volatility of different diversified portfolios

	YTD (%)	1 Year (%)	3 Years (%)	5 Years (%)	7 Years (%)	Common inception (%)
Conservative A	8.87	7.68	5.02	4.25	4.08	4.07
Conservative B	9.34	8.09	5.26	4.48	4.28	4.27
Conservative C	8.27	7.16	4.69	4.00	3.85	3.85
Balanced A	19.30	16.67	10.77	9.05	8.46	8.29
Balanced B	19.43	16.79	10.84	9.12	8.52	8.35
Balanced C	18.56	16.04	10.34	8.71	8.15	8.00
Growth A	23.32	20.13	12.97	10.89	10.14	9.91
Growth B	23.40	20.21	13.01	10.93	10.17	9.95
Growth C	22.33	19.28	12.41	10.44	9.73	9.52

Source: Morningstar Direct, VanEck. Common inception date is 1 January 2013. Volatility is Standard Deviation of returns. Results are calculated monthly and assume immediate reinvestment of all dividends. You cannot invest in an index. Past performance is not a reliable indicator of future performance. See the Appendix for asset allocation and indices used.

Figure 8: Sharpe ratio of different diversified portfolios

	YTD	1 Year	3 Years	5 Years	7 Years	Common inception
Conservative A	0.08	0.10	0.86	0.99	1.08	1.10
Conservative B	-0.03	0.00	0.83	0.95	1.06	1.08
Conservative C	0.05	0.06	0.90	1.02	1.12	1.13
Balanced A	-0.17	-0.04	0.53	0.70	0.76	0.84
Balanced B	-0.18	-0.05	0.52	0.70	0.76	0.84
Balanced C	-0.20	-0.07	0.54	0.71	0.78	0.85
Growth A	-0.19	-0.05	0.48	0.66	0.71	0.79
Growth B	-0.20	-0.06	0.48	0.66	0.71	0.79
Growth C	-0.23	-0.08	0.49	0.67	0.74	0.81

Source: Morningstar Direct, VanEck. Common inception date is 1 January 2013. Results are calculated monthly and assume immediate reinvestment of all dividends. You cannot invest in an index. Past performance is not a reliable indicator of future performance. See the Appendix for asset allocation and indices used.

In each instance above the 'B' portfolios outperform over the medium and long terms, however this comes with marginally higher standard deviation.

The Sharpe ratio combines the return measure with the volatility measure to quantify the relationship between the returns and risk. It provides a measure of risk-adjusted performance. What this means is that while the 'C' portfolios have the lowest returns in figure 6, when you consider their lower volatility in figure 7, the results show the 'C' portfolios have the best risk adjusted returns.

EM bonds can improve the returns of diversified portfolios that use EM bonds as a part of a fixed income allocation. They can also improve the risk-adjusted returns of diversified portfolios that treat EM bonds as its own asset class as they would alternative assets.

Based on the above historical analysis, portfolio returns would have been enhanced by an allocation to EM bonds.

So far this analysis has been all backward looking, using metrics representing what happened. If we shift to a more forward-looking, fundamentally-based approach, we see another argument in favour of an allocation to EM bonds.

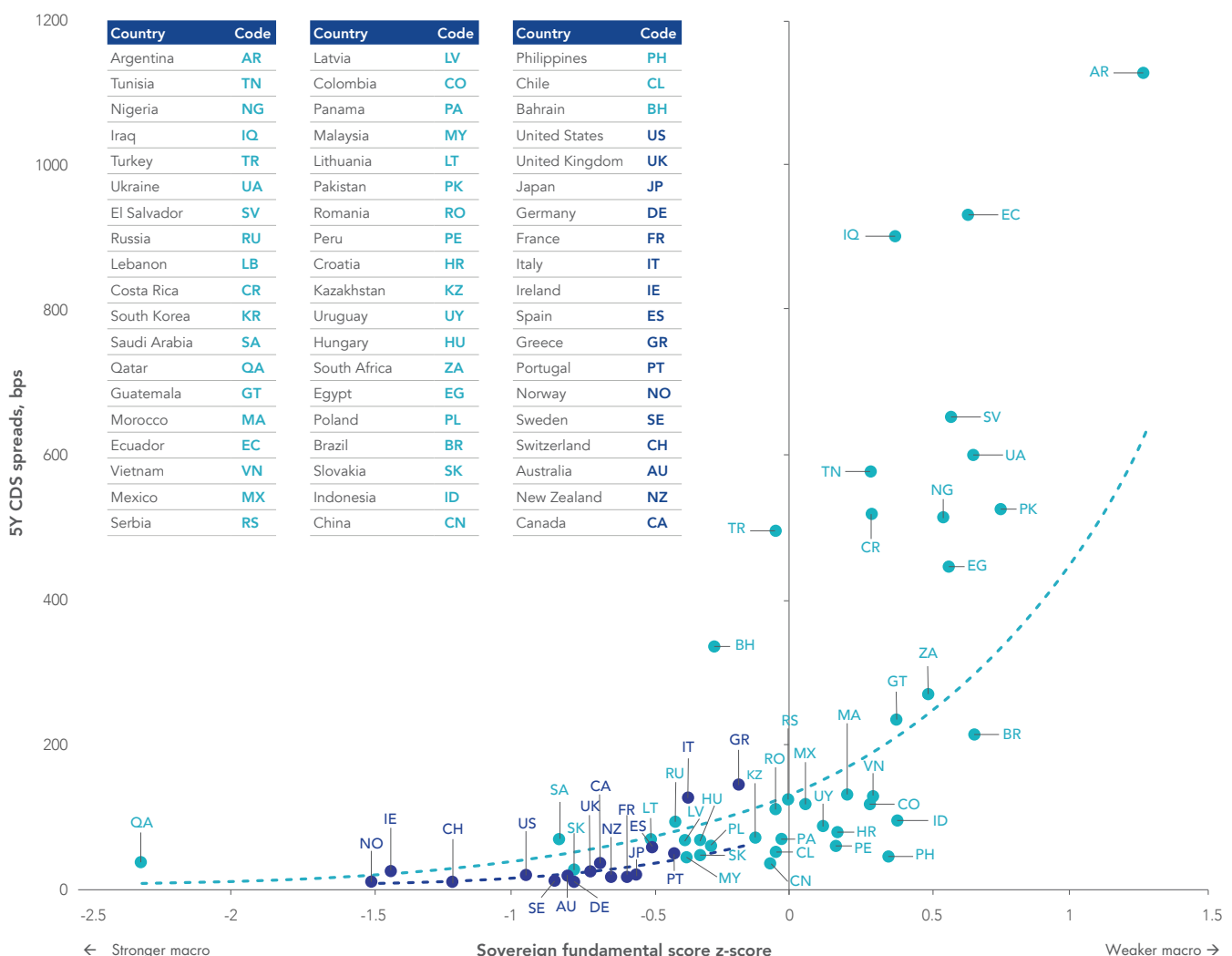
A forward-looking fundamentally based approach in favour of EM bonds

Based on fundamentals, EM bonds deliver a higher return and lower risk than DM bonds. In Figures 9 and 10, the x-axes on both represents the fundamental score for countries, which VanEck has calculated based on a range of solvency measures (e.g. government debt-to-GDP), liquidity measures (e.g. current account deficits), and structural measures (e.g. banking system common equity to assets). On the left of the x-axes are countries with "strong" scores relative to other countries (e.g. low debt-to-GDP) and on the right are countries with "weak" scores.

In Figure 9, the y-axis is the spread, the difference between the yield paid by the emerging market bonds compared to the yield of US government bonds of a similar maturity. We show individual countries and a regression line representing countries that are considered "emerging markets", and another regression representing countries that are considered "developed markets".

The emerging markets trend regression line shows consistently higher spreads (for hard currency bonds) and higher real yields (for local currency bonds) than the spread and real yield for same-rated DM bonds. In other words, EM bonds deliver a higher premium to investors for similar fundamentals. We performed a similar exercise for local-currency bonds and come to the same conclusion – that EM bonds provide much higher premia relative to DM bonds with the same fundamentals.

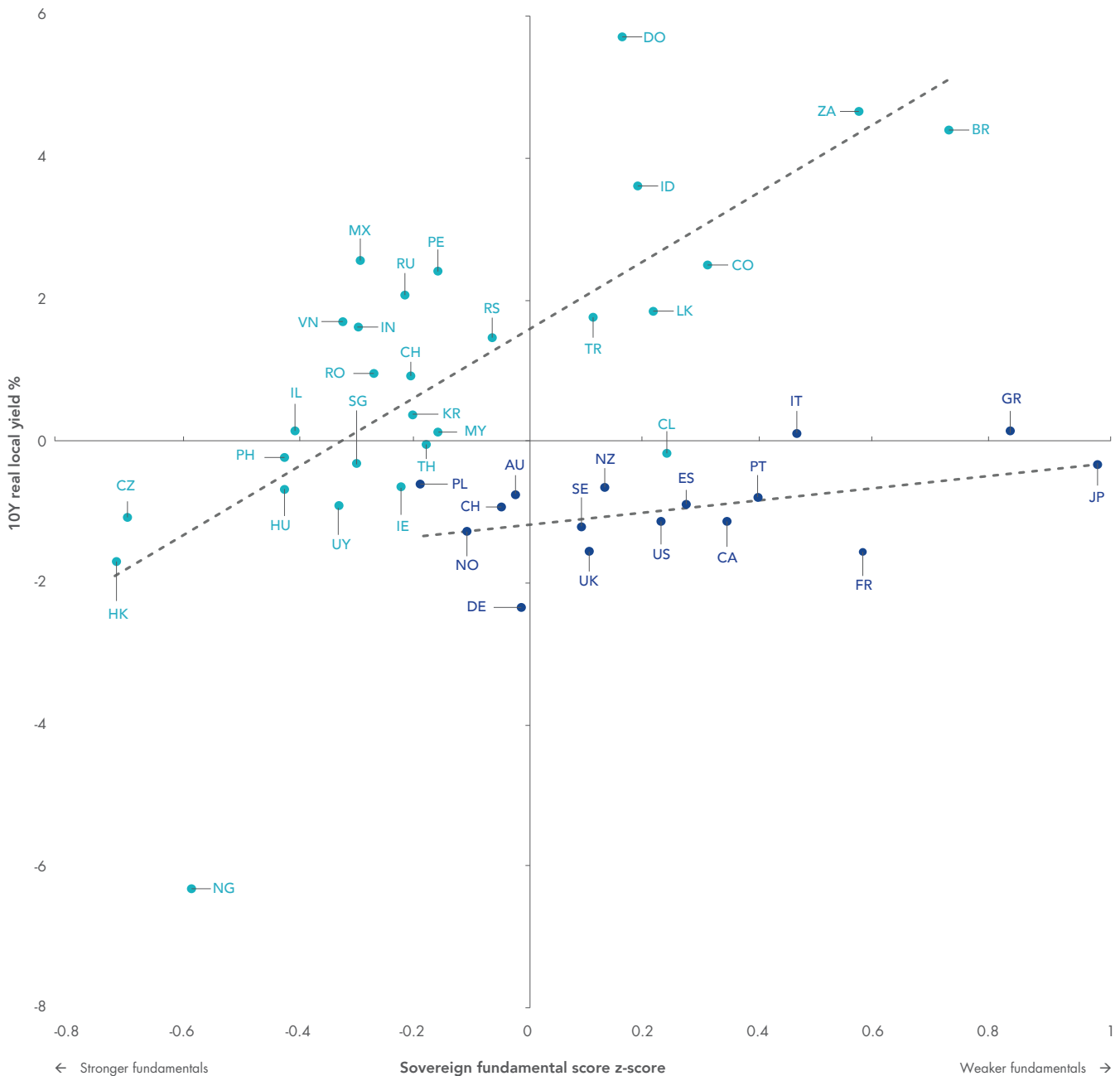
Figure 9: 5Y sovereign CDS spreads and sovereign "fundamental" scores



Source: VanEck Research, Moody's, IMF, World Bank, Bloomberg. Data as of 30 September 2020.

In Figure 10, you'll see the same fundamental score on the x-axis, and on the y-axis we measure the real yield of the major emerging markets that issue bonds in local currency compared to DM bonds. Bonds issued by countries that happen to be emerging markets pay higher real yields across fundamental quality. This is another powerful argument supporting allocations to EM bonds, particularly in an era of central bank experimentation, rising debt, and other risks that now characterise developed markets.

Figure 10: 10Y real local yield and sovereign fundamental score



Country	Code	Country	Code	Country	Code	Country	Code	Country	Code	Country	Code
Argentina	AR	Hungary	HU	Peru	PE	Thailand	TH	Germany	GR	Sweden	SE
Brazil	BR	India	IN	Philippines	PH	Turkey	TR	France	FR	Switzerland	CH
Chile	CL	Indonesia	ID	Romania	RO	Uruguay	UY	Italy	IT	Australia	AU
China	CN	Israel	IL	Russia	RU	Vietnam	VN	Spain	ES	New Zealand	NZ
Colombia	CO	Ireland	IE	Singapore	SG	Serbia	RS	Greece	GR	Canada	CA
Czech Republic	CZ	Malaysia	MY	South Africa	ZA	United States	US	Poland	PL		
Dominican Republic	DO	Mexico	MX	South Korea	KR	United Kingdom	UK	Portugal	PT		
Hong Kong	HK	Nigeria	NG	Sri Lanka	LK	Japan	JP	Norway	NO		

Source: VanEck Research, Moody's, IMF, World Bank, Bloomberg. Data as of 30 September 2020.

The above analysis shows on both backward and forward looking metrics, EM bonds should be considered as part of a diversified portfolio.

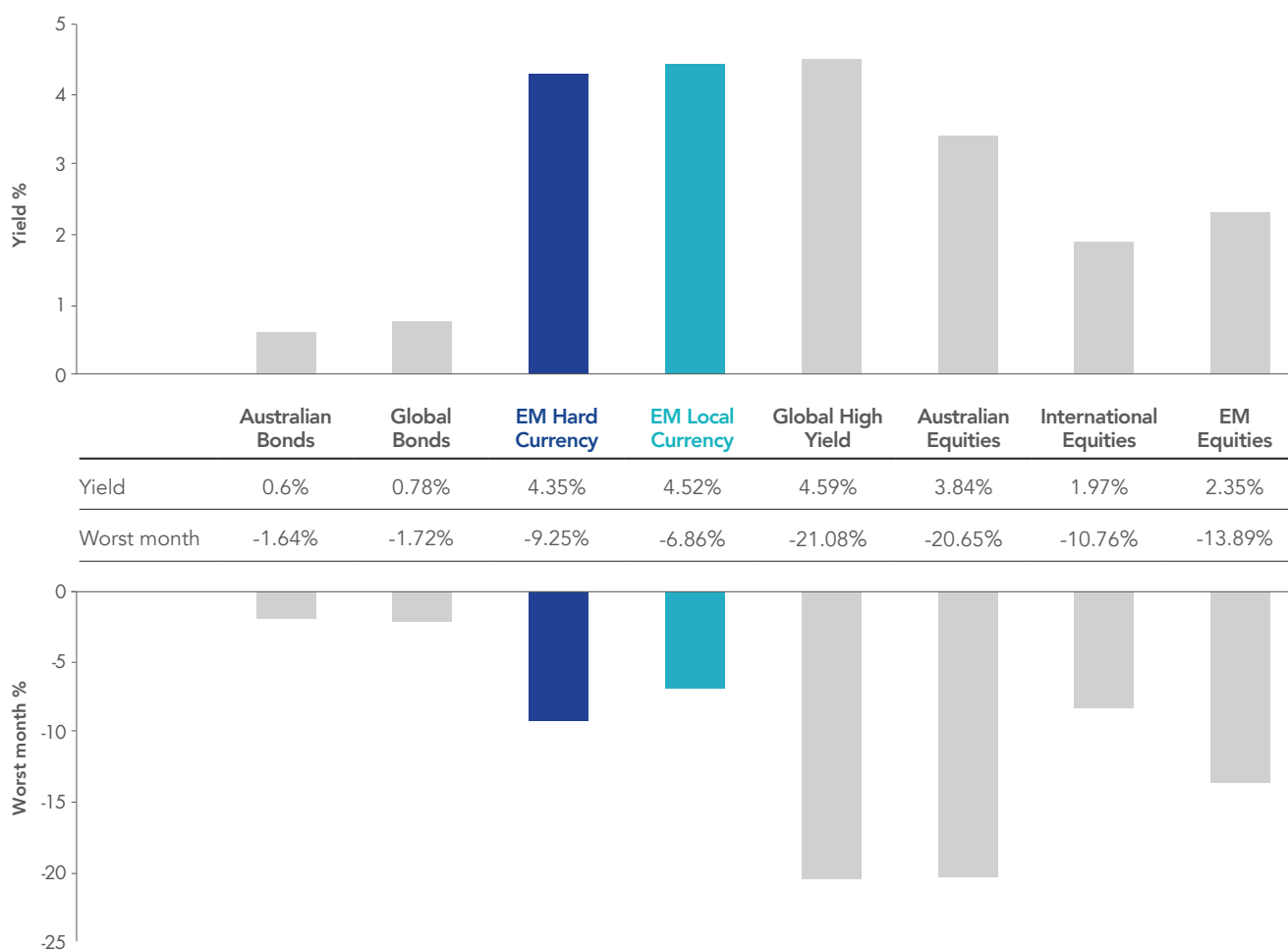
Allaying fears about 'old world' losses

For investors focused on yield, EM bonds can also enhance a portfolio's income. EM bonds offer access to debt with attractive yields relative to DM bonds.

Now with DM bond yields and cash rates so low, many investors are exploring other asset classes including high yield bonds and equities. While they often consider volatility, EM bonds have historically been overlooked because investors fear the significant losses experienced in the old world. This is the new world.

The graph below shows the yield of each asset class as at 30 September 2020 (top half) and the worst monthly fall experienced in the last 15 years capturing the GFC and the COVID-19 crisis (bottom half).

Figure 11: Yields as at 30 September 2020



Source: Bloomberg Direct, Worst monthly performance: 1 October 2005 to 30 September 2020 and yield is either yield to maturity (for bonds) or dividend yield (for equities) as at 30 September 2020. Results are calculated weekly and assume immediate reinvestment of all dividends. You cannot invest in an index. Past performance is not a reliable indicator of future performance. Yield to maturity is the estimated annual rate of return that would be received if the index's current securities were all held to their maturity and all coupons and principal were made as contracted. Dividend yield is the weighted average of each security's distributed income during the prior twelve months. Yield does not account for fees or taxes. Yield is not a forecast, and is not a guarantee of, the future return of the index which will vary from time to time. Indices used: **Global Bonds** – Barclays Global Aggregate Bond Index A\$ Hedged; **Australian Bonds** – Bloomberg AusBond Composite 0+ Yr Index; **EM Hard Currency** – J.P. Morgan Emerging Markets Bond Index Global Diversified (EMBIGD) – EMBIGD is unhedged, EMBIGD will hedge its hard currency; **EM Local Currency** – J.P. Morgan Government Bond Index-Emerging Markets Global Diversified (GBI-EM); **Global High Yield** – International Equities – MSCI World ex Australia Index; **Global High Yield** – Markit iBoxx Global Developed Markets Liquid High Yield Capped Index (AUD Hedged); **Australian Equities** – S&P/ASX 200 Accumulation Index; **EM Equities** – MSCI Emerging Markets Index.

The above chart does not consider the different risk profile of the different asset classes shown.

The worst monthly falls in the new world of the last 15 years were in the asset classes most investors are now considering to enhance their yield: global high yield and Australian equities.

The fears around EM bonds from the old world appear unfounded in the new world.

Allaying fears around defaults

Another misapprehension about EM bonds is default rates. This is because the negative news of a default captures the media's attention. An emerging market government meeting its debt obligations is unlikely to sell many papers.

According to JP Morgan data, there is less reason to be afraid of EM corporate bonds than DM high yield bonds. For example, emerging markets corporates high yield defaults stood at 2.9% through September 2020, well below the default rates experienced in the US and in line with those in Europe. JP Morgan expects by the end of 2020 emerging markets defaults will be lower than developed markets.

Figure 11: Global comparison between emerging markets corporate, sovereign and developed markets credit default rates

	2013	2014	2015	2016	2017	2018	2019	2020YTD	2020F	2021F
Asia	1.2%	1.5%	3.1%	1.0%	1.0%	2.5%	1.6%	2.4%	3.0%	NA
EM Europe	2.3%	4.0%	2.5%	3.6%	3.6%	0.0%	0.0%	3.4%	3.9%	NA
Latin America	10.6%	6.5%	5.7%	9.2%	2.0%	2.1%	2.3%	4.1%	4.6%	NA
Middle East & Africa	0.0%	4.6%	4.0%	5.7%	3.2%	0.0%	1.6%	1.8%	2.6%	NA
EM Corp HY	4.3%	3.8%	3.8%	5.1%	2.2%	1.6%	1.5%	2.9%	3.5%	NA
Developed markets default rates										
US HY	0.7%	3.0%	2.6%	4.3%	1.5%	1.9%	2.9%	6.0%	6.5%	4.0%
European HY	1.7%	0.9%	1.2%	2.5%	1.1%	1.4%	1.8%	2.9%	4.0%	3.0%

Source: J.P. Morgan. Note: ex-100% basis for EM Corp. European HY default rate is on LTM basis.

As we noted earlier, emerging markets entered the COVID-19 crisis more fiscally fit than their developed markets counterparts, with less leverage and stronger fundamentals. So it is not surprising then that the default rate of EM bonds are comparable with DM bonds in 2020.

The COVID-19 crisis is an example of the new-world. Some EM bonds realised the greatest gains in the fixed income world post the crisis and we believe carefully selected EM bonds can continue to deliver strong returns into the future.

Look beyond the noise

The term 'EM' captures a number of economies. What the headlines tend to miss are the many individual EM countries and economies that are well managed, as well as the resilience of specific bond issuers.

During the COVID-19 crisis both Lebanon and Ecuador defaulted. The troubles in Argentina have been well publicised. It's important to look beyond the noise.

This is where active management in EM bonds can come to the fore. Active management allows the manager to avoid those countries with weaker fundamentals and prefer those emerging market economies that are better managed and therefore better insulated from shocks such as the contraction in international trade due to a COVID-19 event.

Accessing EM bonds

VanEck Emerging Income Opportunities Active ETF (Managed Fund) (ASX: EBND) is an actively managed fund that is available on ASX. The manager takes an unconstrained approach.

The benefits of EBND's unconstrained approach:

- **Flexibility:** EBND has the flexibility to invest in all types of EM bonds: sovereigns and corporates in hard and local currencies.
- **Greater ability to diversify:** EBND's investment team attempts to exploit the different risk and return characteristics of various EM bonds and currencies to optimise country and portfolio risk-adjusted returns. With its unconstrained approach, the team has a greater ability to maintain exposure to attractive yields while diversifying by currency, region, maturity, duration and credit.
- **Conviction:** EBND will often be composed of high-conviction investments, with a maximum weighting of 15%.
- **Contrarian views:** The investment team avoids crowded investments and often strives to find the next best investment ahead of other investors.

Conclusion

EM bonds have some unique advantages in a fixed income portfolio. Based on the efficient frontier analysis, most investors have under-allocated to the sector. EM bonds can improve the returns of diversified portfolios that use EM bonds as a part of a fixed income allocation, they can also improve the risk-adjusted returns of diversified portfolios that treat EM bonds as its own asset class as they would alternative assets. Investors are better rewarded for EM bonds because they pay a higher premium for the same fundamentals as DM bonds.

As you consider your portfolio in the new world, our analysis suggests an allocation to EM bonds in a diversified portfolio should be more than zero.

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Appendix

Set A – Baseline asset allocation (excludes EM bonds)

	Conservative Portfolio A ¹	Balanced Portfolio A (APRA Product A) ²	Growth Portfolio A ³
Growth	30%	71%	85%
Defensive	70%	29%	15%
Australian Equity	11%	25%	30%
International Equity (hedged)	6%	16%	19%
International Equity (unhedged)	6%	16%	19%
Australian Property	4%	10%	12%
Infrastructure	4%	5%	7%
Australian Fixed Income	25%	10%	5%
International Fixed Income	32%	13%	7%
Cash	12%	5%	1%

Set B – EM bonds as 25% of global fixed income

	Conservative Portfolio B	Balanced Portfolio B	Growth Portfolio C
Growth	30%	71%	85%
Defensive	70%	29%	15%
Australian Equity	11%	25%	30%
International Equity (hedged)	6%	16%	19%
International Equity (unhedged)	6%	16%	19%
Australian Property	4%	10%	12%
Infrastructure	4%	5%	7%
Australian Fixed Income	25%	10%	5%
International Fixed Income	24%	10%	5%
Increased allocation from zero	8%	3%	2%
Cash	12%	5%	1%

Set C – EM bonds as a separate asset class per APRA's "other" allocation, treated as 50% growth / 50% defensive

	Conservative Portfolio	Balanced Portfolio	Growth Portfolio
Growth	29%	70%	85%
Defensive	71%	30%	15%
Australian Equity	10%	24%	28%
International Equity (hedged)	5%	15%	18%
International Equity (unhedged)	5%	15%	18%
Australian Property	3%	9%	11%
Infrastructure	4%	5%	7%
EM Bonds	6%	7%	9%
Australian Fixed Income	24%	9%	4%
International Fixed Income	31%	11%	4%
Cash	12%	5%	1%

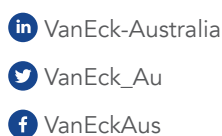
1. VanEck blend of APRA and MoneySmart portfolios. 2. APRA Balanced portfolio. 3. VanEck blend of APRA and MoneySmart portfolios

Indices used

Australian Equity	S&P/ASX 300
International Equity (hedged)	MSCI All Country World ex Australia Index (100% hedged to AUD)
International Equity (unhedged)	MSCI All Country World ex Australia Index
Australian Property	S&P/ASX 300 A-REIT Index
Infrastructure	FTSE Developed Core Infrastructure Index hedged to AUD
EM Bonds	50% JPM EMBI Global Diversified and 50% JPM GBI-EM Global Diversified.
Australian Fixed Income	Bloomberg AusBond Composite 0+ Index
International Fixed Income	Barclays Global Aggregate Bond Index A\$ Hedged
Cash	Bloomberg AusBond Bank Bill Index

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