

Emerging strength

Why EM Bonds are the future
of fixed income

June 2025

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Introduction

Many Australian investors' fixed income portfolios do not include an allocation to emerging markets (EM) bonds. Over the past 25 years EM governments have gone from being in deficit to running up surpluses while developed market (DM) governments have been accruing deficits. This change has resulted in a shift in the origin of bond crises since the turn of the millennium.

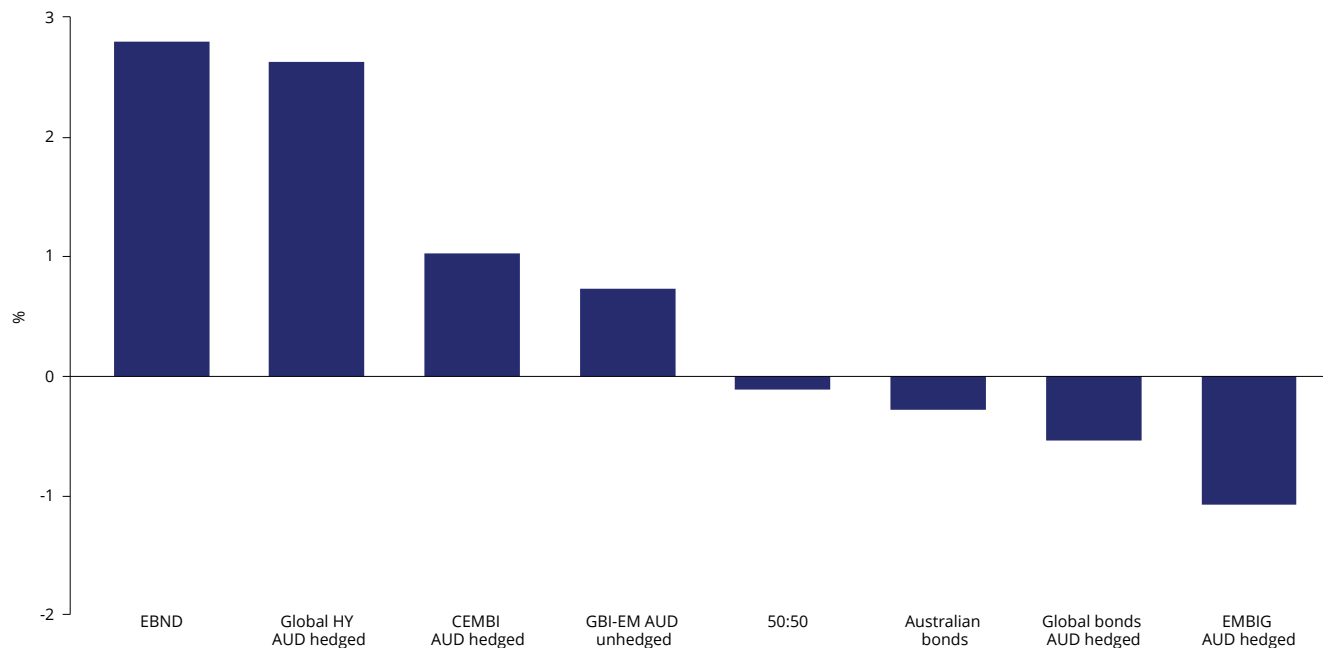
Fixed income portfolios have yet to reflect this new reality. We think EM bonds are the future of fixed income. Because of the idiosyncrasies between the nations included in the EM universe and the nuances between the different types of bonds available, we think an active, unconstrained approach, like the one employed by VanEck's Emerging Income Opportunities Active ETF (EBND), is an ideal way for investors to access this important asset class.

We launched EBND, our flagship EM bond strategy, on ASX five years ago. The ETF is designed to invest in all EM bonds: hard-currency sovereign, local-currency sovereign, and hard-currency corporate bonds. To call the last five years in markets as tumultuous understates the swings experienced. Yet despite the fund being launched into the COVID lockdowns and then navigating Russia's invasion of Ukraine war, and a property crisis in China, EBND was the best performing fixed income ETF on ASX over the past five years¹. The fund is also a top performer among its EM Bond peers, including other EM Blend funds (which invest in local and hard currency) and local or hard currency only EM funds.

When considering the asset class, using EBND's *benchmark*² which was subject to the crises noted above but without any active management, it has outperformed major DM global bond markets. It is therefore surprising that EM bonds remain under owned. It is either a misunderstanding of the different risk-return profile since the turn of the century or the challenge of access.

1. Source: Morningstar Direct, 31 March 2025, Global Broad Category Group – Fixed income, universe of 35 ETFs.

2. The benchmark is 50% J.P. Morgan Emerging Market Bond Index Global Diversified Hedged AUD and 50% J.P. Morgan Government Bond-Emerging Market Index Global Diversified.

Chart 1: Returns of EBND since inception (11 February 2020) compared to other fixed income asset classes

Source: VanEck, Bloomberg to 31 March 2025. Returns are annualised. Global HY AUD hedged Index is Bloomberg Global High-Yield Index (hedged AUD) Index. CEMBI AUD hedged (US dollar-denominated bonds issued by emerging market corporate entities) is the J.P. Morgan CEMBI Broad Diversified Core Index Hedged AUD. GBI-EM AUD unhedged (local currency bonds issued by emerging markets governments) is J.P. Morgan Government Bond-Emerging Market Index Global Diversified, 50:50 Index is 50% J.P. Morgan Emerging Market Bond Index Global Diversified Hedged AUD and 50% J.P. Morgan Government Bond-Emerging Market Index Global Diversified, Australian bonds is Bloomberg AusBond Composite 0+Y Index, Global bonds AUD hedged is Bloomberg Global Aggregate Hedged to AUD Index, EMBIG AUD hedged (hard currency denominated bonds issued by emerging market governments) is J.P. Morgan Emerging Market Bond Index Global Diversified Hedged AUD. EBND inception date is 11 February 2020.

Performance is calculated net of management fees, calculated daily but does not include brokerage costs or buy/sell spreads of investing in EBND. Past performance is not a reliable indicator of future performance.

Bloomberg AusBond Composite 0+Y Index and the Bloomberg Global Aggregate Hedged to AUD Index are shown for comparison purposes only and have been selected as they are the widely recognised benchmarks used to measure the performance of developed markets bonds that make up most Australian bond portfolios.

It is worthwhile to examine the dynamics behind this performance. In this paper, we will discuss:

- **The fundamental case for EM bonds.** EM are generally characterised by low debt levels, higher spreads and independent central banks that maintain higher real policy rates. Many EM countries have stable governments and policies. There are also many winners from DM 'geopolitics' in EM. EM has also benefited from its good policy and DM de-globalisation.
- **EBND's and the asset class's performance, highlighting key themes from the past five years' return history.** Since EBND's inception, EM bonds (as represented by 50% J.P. Morgan Emerging Market Bond Index Global Diversified Hedged AUD and 50% J.P. Morgan Government Bond-Emerging Market Index) have outperformed DM bonds (as represented by Bloomberg Global Aggregate Hedged to AUD Index) on return and volatility-adjusted return bases. Over that time, the many 'advanced' EM countries' local currency bonds behaved like a reserve asset.
- **EBND's investment process** that compares fundamentals to bond premia to generate a list of the cheapest EM bonds regardless of whether they are hard-currency or local-currency. We will also address how the fund was managed to avoid the three big EM challenges in the past five years.
- **The case that long-term investors should use a blend EM bond approach that can invest in all EM bonds.**

The fundamental case for EM bonds

EM generally have lower levels of government and/or total economy debt. This allows central banks to have independence so they can focus solely on inflation and are not constrained by concerns about undermining government financing. As they are independent, EM central banks are also maintaining high real policy rates that keep market rates attractive to those of DM countries. Further, we think DM are generally facing headwinds from geopolitical developments, while many EM are experiencing tailwinds from geopolitical developments.

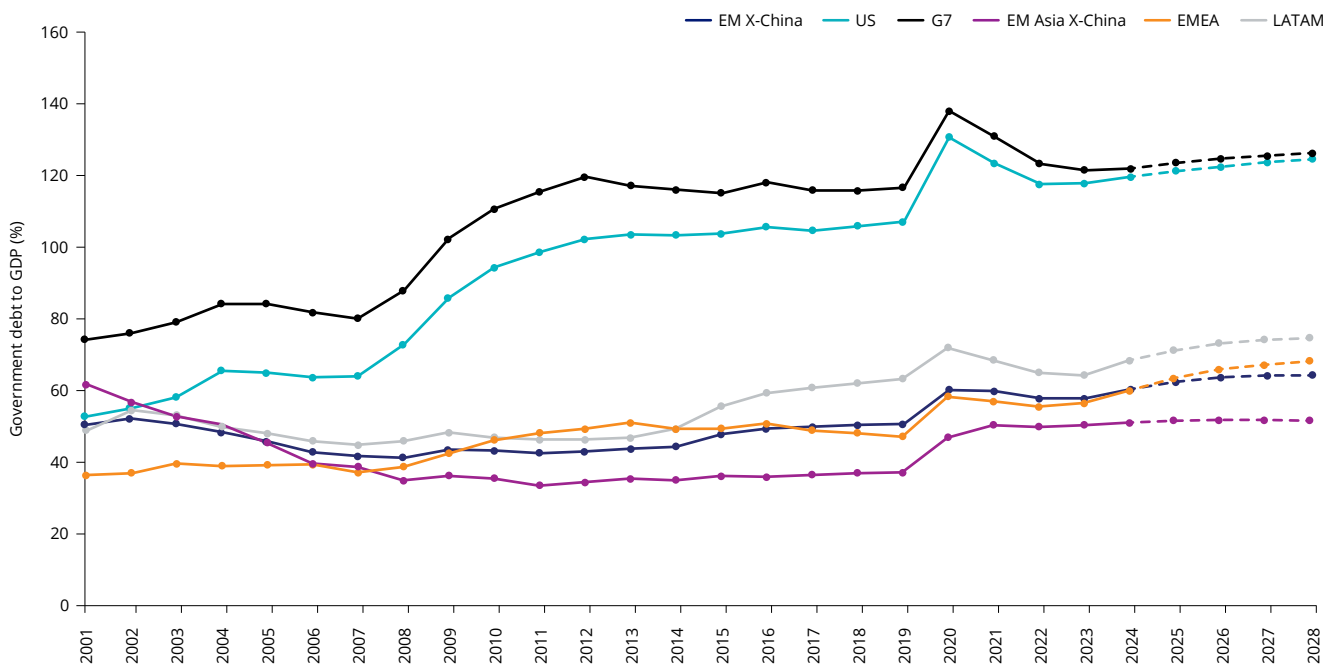
Chart 2 below shows EM central government debt levels, which are lower than those in DM. This is the result of decades of fiscal prudence and central bank independence, particularly in Asia, put in place after the 1997 Asia Crisis (please see Appendix 1 for a transcript of our Portfolio Manager’s play-by-play on the Asia crisis, and how this spread economic orthodoxy to EMs, via the “Washington Consensus”).

It is also worth noting that EM have lower total economy (i.e. private) debt than DM. An important point is that how governments treat private debt in their economies might also differ between key EM and DM. Since the GFC, DM central banks have taken risky assets onto their balance sheet, including high yield (HY) ETFs, as was the case with the US. This can stabilise markets, but the moral hazard is that it creates market distortions.

Contrast this with China’s recent property crisis, in which policymakers avoided taking these entities onto their balance sheet. This led to collapses in investment grade (IG) corporate bonds. But this was a problem for the fund manager, nobody was forcing anyone to invest in that sector when it was trading at par. For further insight of how EBND handled the China property crisis, which boiled down to not owning any in the lead up to the crisis because it was expensive and didn’t qualify as an eligible investment, see page 23.

In comparing the US and China’s approaches, it is orthodox policy not to guarantee corporate risks, however much short-term pain this entails. That’s the key point, EM, such as China, have shown great caution over debt levels, which protects their economies.

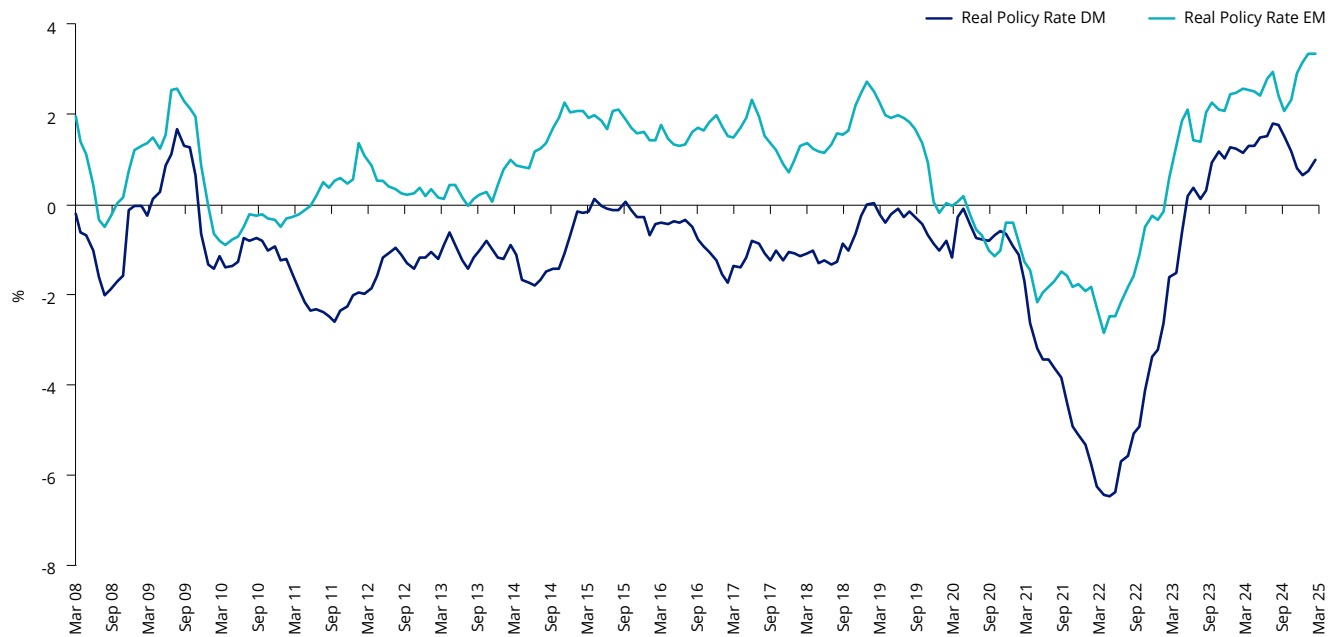
Chart 2: EM central general government debt lower than DM



Source: IMF, Bloomberg, December 2024. Data after 2024 represents IMF forecasts.

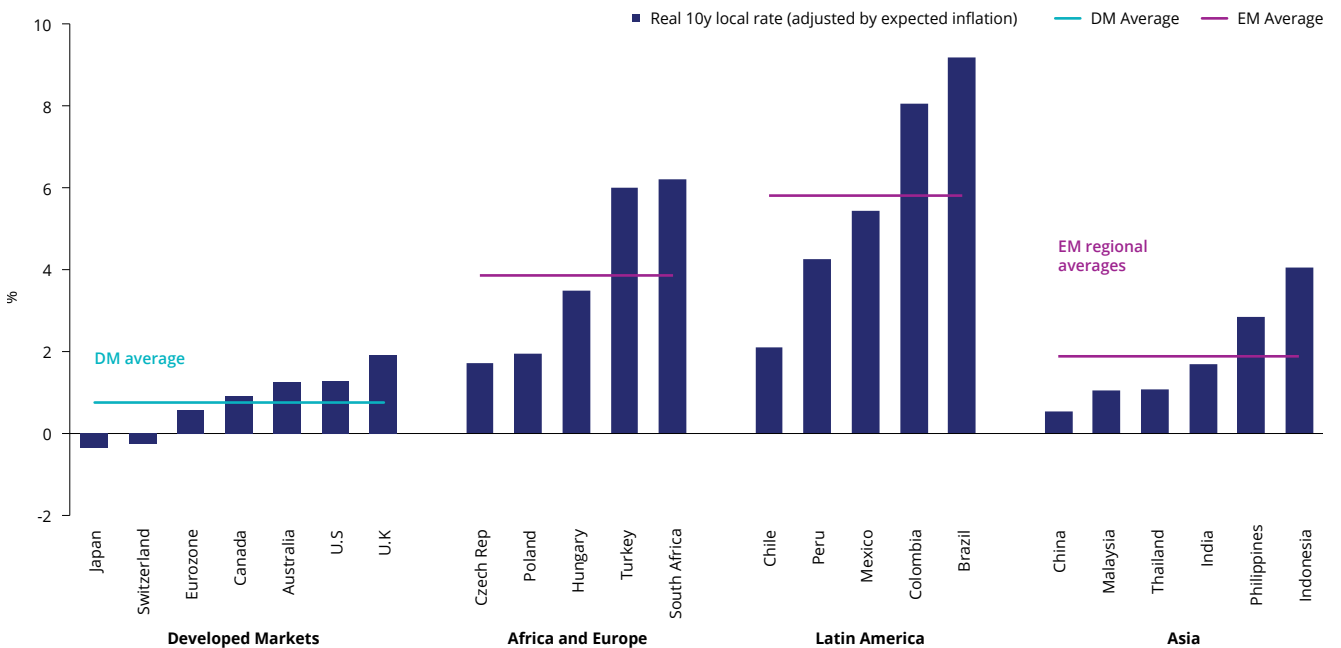
The result is high real policy and market rates in EM. This initial condition of low debt levels allows central banks to focus primarily on inflation, as the maintenance of high real policy rates doesn't create financing risks for its country's government, (*Fiscal dominance: Emerging markets' upper hand*, is a full discussion on the excessive debt, or fiscal dominance, characterising many DMs, available here: www.vaneck.com.au/library/whitepapers). This central bank independence is illustrated by the history of real policy rates in EM versus DM below. It shows what one would expect, consistently higher real interest rates than DM.

Chart 3: Real policy rates in EM versus DM



Source: VanEck Research; Bloomberg LP. March 2025.

Chart 4: Real market rates, by region/country

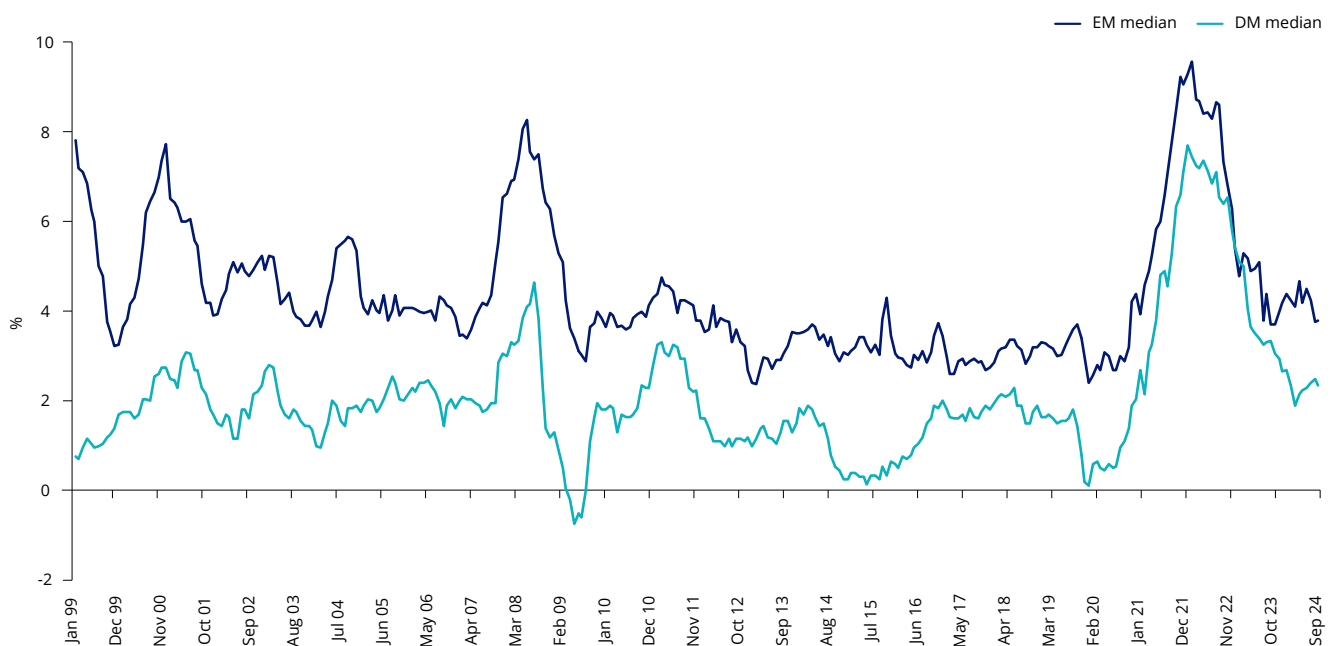


Source: VanEck Research; Bloomberg LP. April 2025.

The result of this independence should have been steadily declining inflation since orthodox policy began to infect EM, which we date at the beginning of 1999 for analytical ease (i.e., following the Latin, Asian, and Russian crises) and to present the full and dramatic picture. This is the ultimate point of economic orthodoxy: a low-inflation, stable currency environment that allows sustainable growth. This sustainable growth is the responsibility of the private sector and good structural policy from the government/political authority, not an additional responsibility of the central bank.

The central bank needs to be as solely focused on inflation as feasible, which is the case in EM. This is exactly what ensued, as is evident in the Chart 5 below. EM inflation is converging to DM inflation. And note the lack of overreaction from EM inflation in the COVID lockdown spike. Due to their strong orthodox bias, EM stopped their fiscal responses earlier than DM. Declining inflation and inflation expectations are the outcome.

Chart 5: EM versus DM median inflation



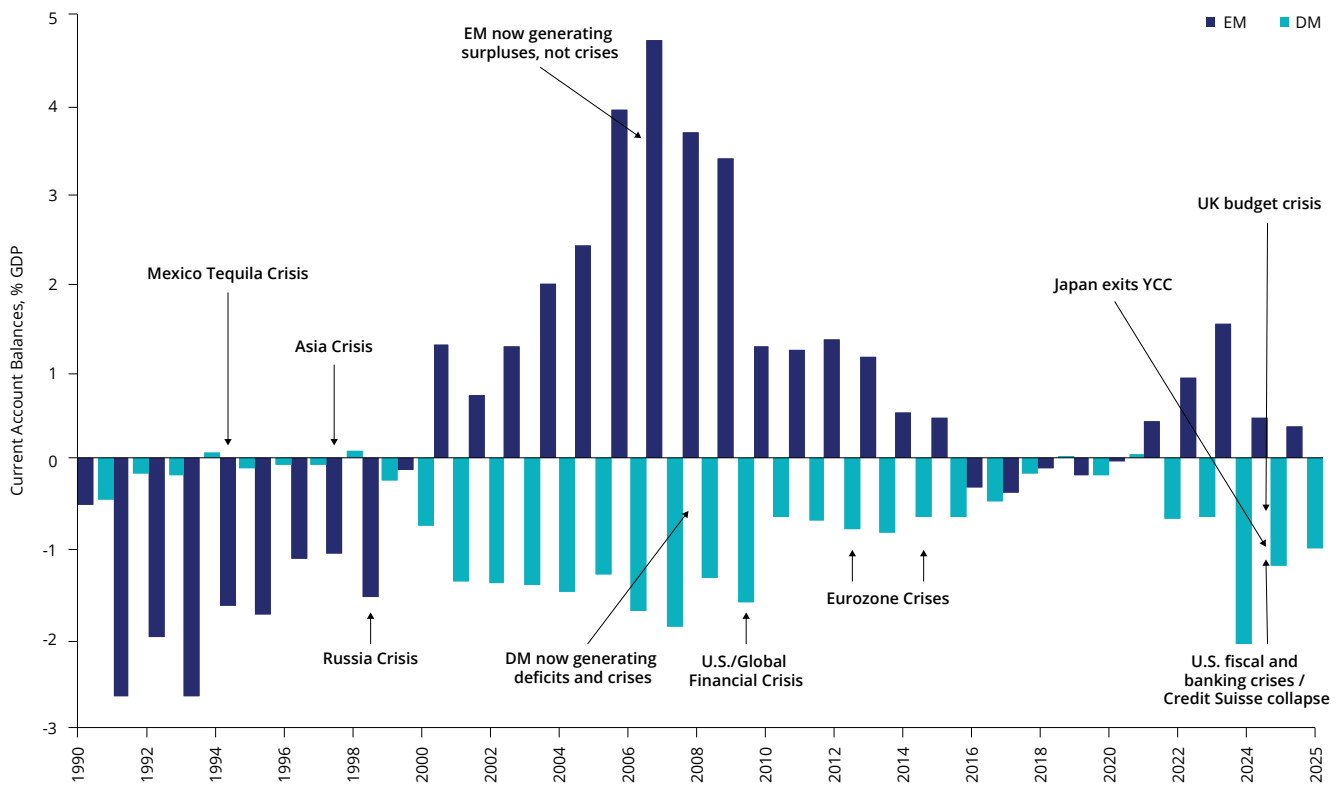
Source: VanEck Research; Bloomberg LP. April 2025.

The shift away from DM to EM is observable and tectonic. We have often used Chart 6 to explain the “fiscal dominance” thesis. It compares EM versus DM current accounts over the past 30 years.

Prior to 1998, EMs were running large and persistent deficits and were responsible for the global financial crises in the 1990s. Since 1998, however, it's the DMs that have been generating large and persistent deficits. DMs have also been responsible for the crises of the new millennium.

We think this is due to “fiscal dominance”, a state in which monetary policy becomes subsumed to fiscal policy. Most generally, after the Latin crises of the 80s and 90s, and the Asia and Russia's crises in 1997 and 1998, EMs, along with the IMF agreed on a “Washington consensus”. Exchange rates were floated, and if inflationary the central bank had to step in with high real rates. If that was recessionary, the recession was allowed. Thailand and Indonesia experienced 50% declines in USD GDP. Fiscal policy was austere, not stimulative. And insolvent financial and industrial institutions were allowed to fail i.e. were not put on the government's balance sheet. You can see the persistent surpluses generated due to these policies in Chart 6. DM's response to the many crises of the past two and a half decades have been the exact opposite. Policies were implemented, resulting in monetary policy enabling fiscal policy, and coordination was celebrated, insolvent financial institutions were guaranteed, recessions were prevented at all costs.

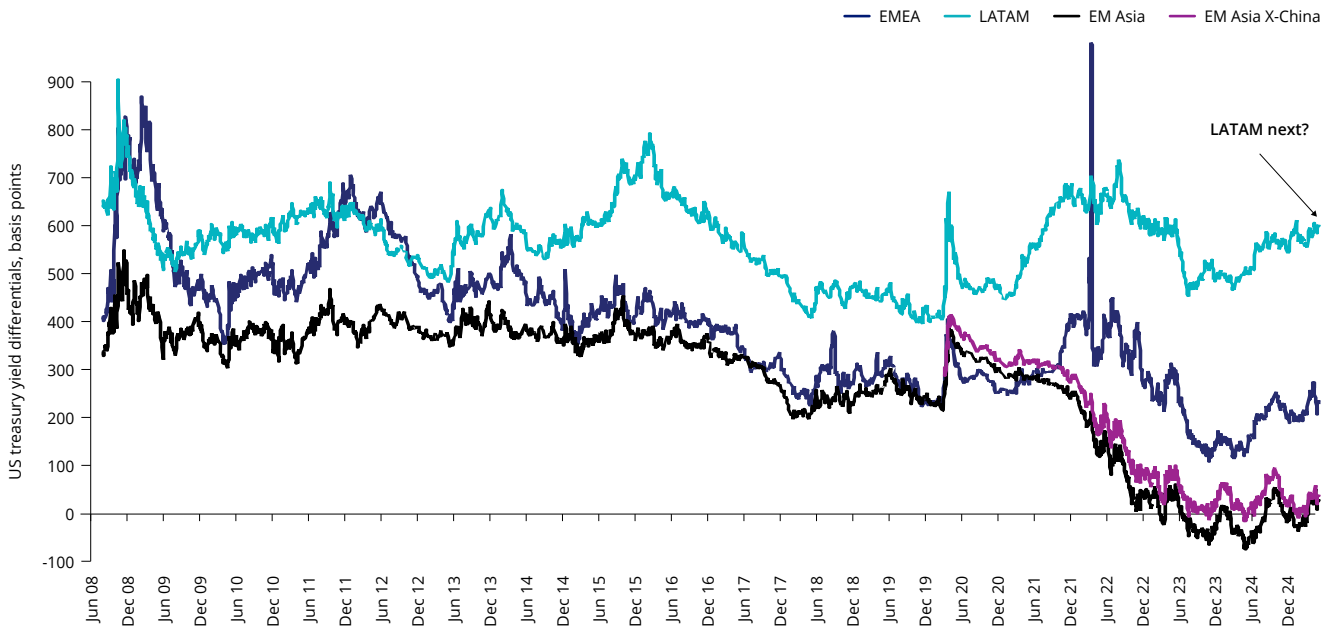
Chart 6: Almost 30 Years of EM Exceptionalism



Source: Bloomberg LP, as of December 2024.

While we discuss EM bond performance in the next section of this paper, one chart is emblematic of EM’s exceptionalism – the behaviour of EM Asian local-currency yields. The chart on the next page shows local currency EM government bonds, as represented by the J.P. Morgan Government Bond-Emerging Market Index Global Diversified (GBIEM) yields minus US yields, by EM region. Asia is the outlier, with yields now comparable to the US’s. EMEA experienced the shock of the Russia/Ukraine war, but is *also* experiencing record-low nominal yields relative to US yields. “Is Latam next?” could be the right question.

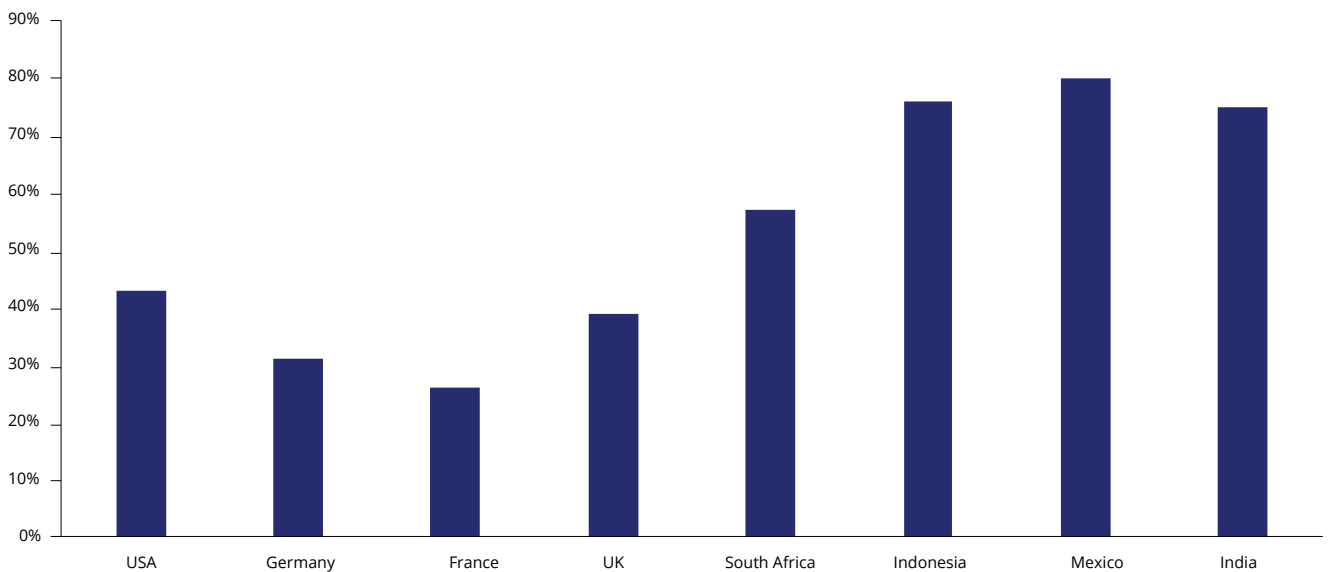
Chart 7: EM Asia and EMEA yields' secular decline, LATAM next?



Source: VanEck, Bloomberg to 31 March 2025. EMEA is J.P. Morgan GBI-EM Global Diversified Europe Index, LATAM is J.P. Morgan GBI-EM Global Diversified Latin America Index, EM Asia is J.P. Morgan GBI-EM Global Diversified Asia, EM Asia x-China is J.P. Morgan GBI-EM Global Diversified Asia ex China Index.

We also think geopolitics is a tailwind for EM. We have established that DM countries have excessive debts, co-opted central banks, and are driving all global financial crises these days. That's the story of Chart 7 above. It's the result of decades of bad policy in DM and good policy in EM. Importantly, in EM these good policies are popular among its citizens. That's why we show Chart 8. It shows the domestic popularity of the leader (or the GNU in South Africa) in some selected countries. Orthodox policy is being rewarded with strong national unity and political strength. This was the profound conclusion that these countries' political systems arrived at: crises need to be avoided, even if it means rigorous policy.

Chart 8: Leader/government approvals. DM leaders are less popular than EM leaders

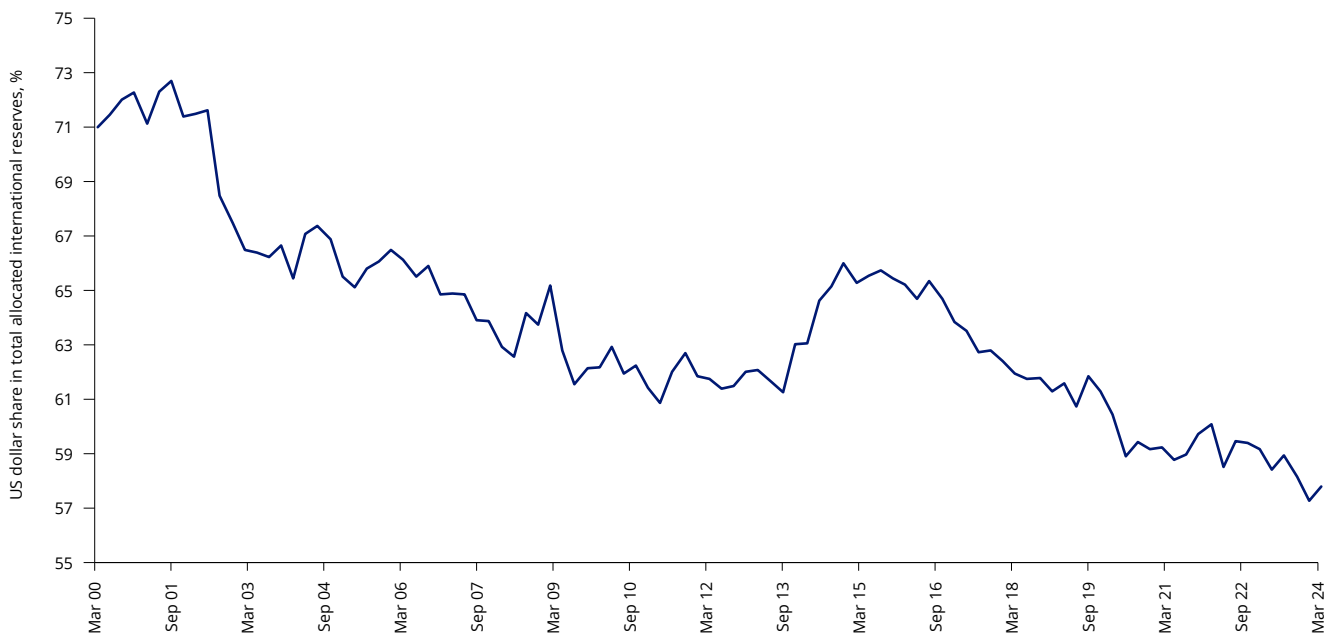


Source: Bloomberg, December 2024.

Another point about geopolitics is that the whole world is not de-globalising. DM is de-globalising via sanctions, and there is a growing rift between the US and China. But the other parts of the world are globalising. All of Russia’s pipes are heading east, generating a permanent and material positive terms-of-trade shock to India and other Asian nations. Markets still can only guess what India is really paying for oil. The BRICS (BRICS is an intergovernmental organisation comprising ten countries – Brazil, Russia, India, China, South Africa, Egypt, Ethiopia, Indonesia, Iran and the United Arab Emirates) was formed to have less dependence on the DM or the US financial system. These are examples of globalisation, to our eyes.

Perhaps the best example is the declining use of US treasuries in central bank reserves. This is also the result of geopolitics, in particular, sanctions. All central banks noticed the sanctions on Russian central bank reserves, and sanctions are now a new risk they can’t ignore. EM is a winner from this dynamic. EM local-currency bonds are increasingly sought by central banks as reserve assets, in addition to gold purchases. This will be a long process, but we think EM bonds are becoming reserve assets, and geopolitical developments are a tailwind for this, as they are a headwind for DM markets.

Exhibit 9: Use of US Treasuries in global central bank reserves at record lows



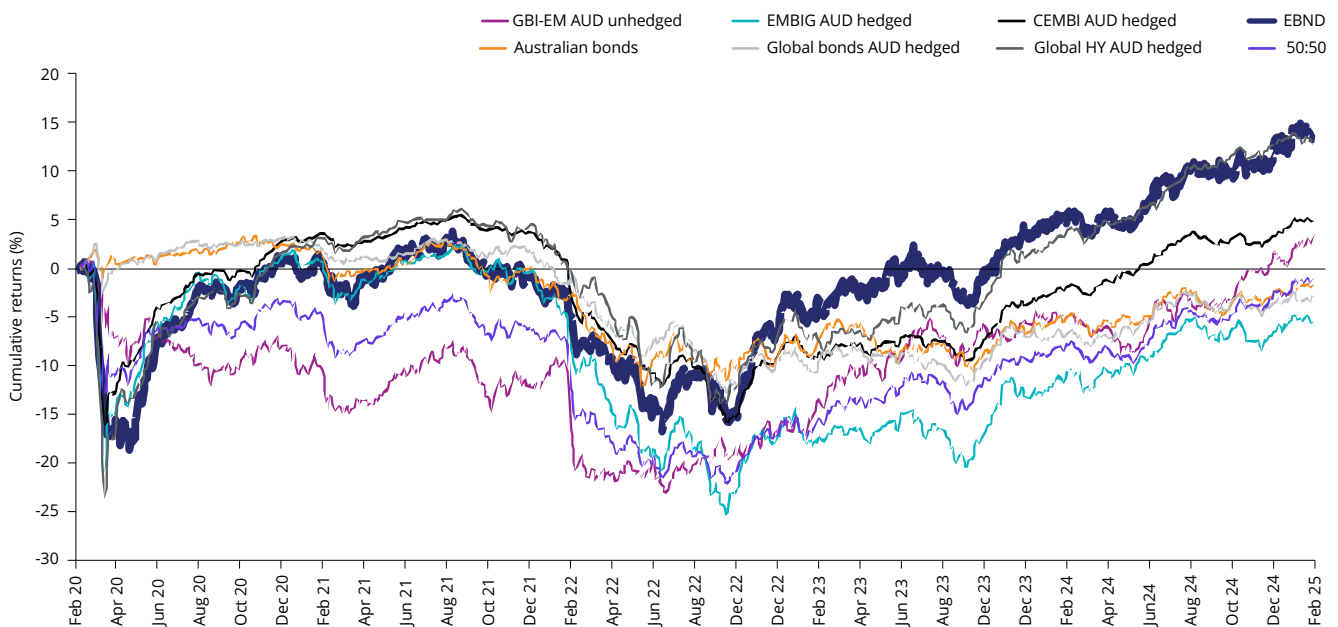
Source: Bloomberg, March 2025.

An analysis of the performance

We highlighted the outright return history of EBND in the first chart of this paper. The below shows the path to that return in more detail. In chart one EBND and High Yield (AUD hedged) performed best overall, noting that high yield is dependent, to a greater extent, on the performance of its Australian dollar hedge than is EBND. This is because EBND does not hedge its local-currency exposure into Australian dollars. This means that EBND investors are getting more return independent of the Australian dollar hedge (for example, 60% of EBND is currently exposed to local currency, and that is not hedged). Your choice of fixed income category should not be a proxy decision on the Australian dollar, when you can avoid it.

The rationale for hedging back to the local currency is to protect against potential currency erosion impacting the income component of return. It's important to note that EBND is only hedged back to Australian dollars up to 50% of its portfolio, has continued to achieve a consistent level of distributions.

Chart 10: Performance since EBND's inception



Source: VanEck, Bloomberg to 31 March 2025. Global HY AUD hedged Index is Bloomberg Global High-Yield Index (hedged AUD) Index. CEMBI AUD hedged (US dollar-denominated bonds issued by emerging market corporate entities) is the J.P. Morgan CEMBI Broad Diversified Core Index Hedged AUD. GBI-EM AUD unhedged (local currency bonds issued by emerging markets governments) is J.P. Morgan Government Bond-Emerging Market Index Global Diversified, 50:50 Index is 50% J.P. Morgan Emerging Market Bond Index Global Diversified Hedged AUD and 50% J.P. Morgan Government Bond-Emerging Market Index Global Diversified, Australian bonds is Bloomberg AusBond Composite 0+Y Index, Global bonds AUD hedged is Bloomberg Global Aggregate Hedged to AUD Index, EMBIG AUD hedged (hard currency denominated bonds issued by emerging market governments) is J.P. Morgan Emerging Market Bond Index Global Diversified Hedged AUD. EBND inception date is 11 February 2020.

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Let’s look at that return stream, starting with the basic exercise of generating an Efficient Frontier. The Efficient Frontier is derived from the Modern Portfolio Theory (MPT), and it suggests the most ‘efficient’ investment portfolios to generate returns for a set level of risk. The risk measure used is the standard deviation of returns.

Below, we show some output from using the frontier only on Australian fixed income choices. These are the fixed-income investments Australian investors consider, including EM debt. Using a longer data stream, going back 20 years (using 50/50 EBND’s benchmark), the conclusion is the same, the optimal allocation to EM in an Australian fixed income portfolio would have been around 27% for a mid-level volatility level of 6.0.

The Efficient Frontier is a formal framework used by investors for thinking about asset allocation, and we wouldn’t suggest an unbounded model. Considering portfolio limits, it’s likely that this optimal allocation of 27% is far *higher* than most investors maintain. The point is that the allocation should be higher than zero. It also means that the optimal allocation to *other* fixed-income categories in the analysis, which tend to be the largest and most popular allocations, like global aggregate or Australian government bonds, is much *lower* than most investors maintain.

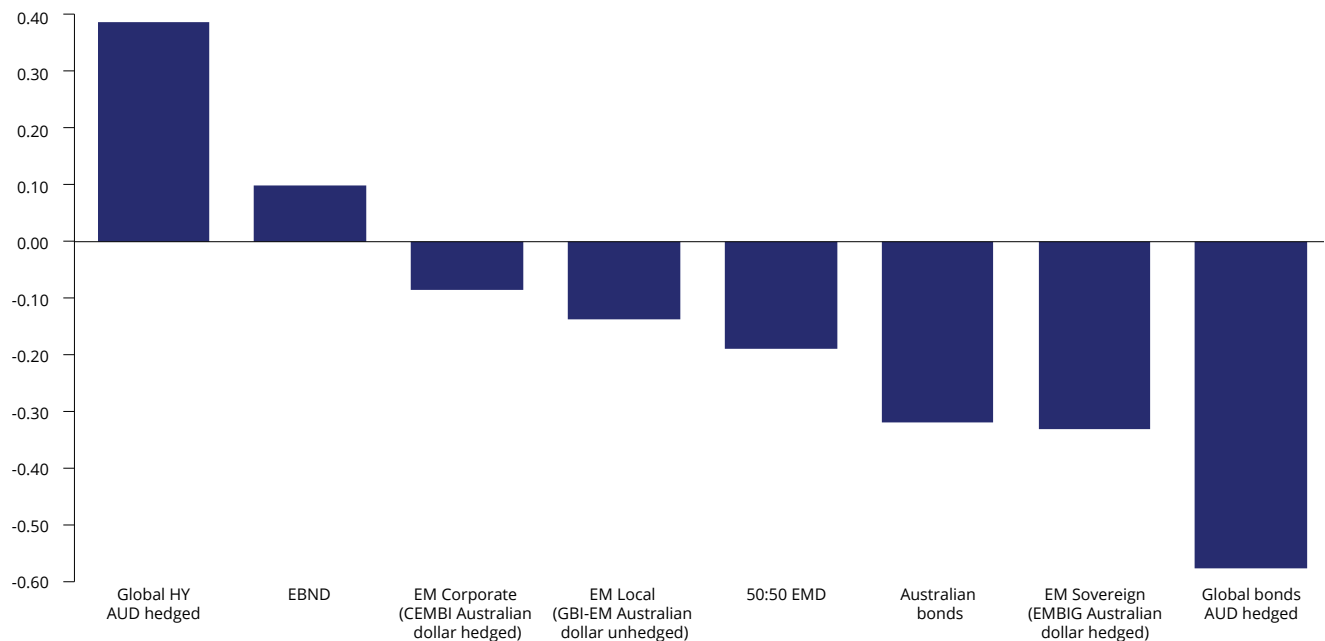
Table 1: What does the efficient frontier say about the optimal level of EM bonds?

	Data set monthly										
	Low risk ←						→ High risk				
Portfolio standard deviation	1.99	3.62	4.50	5.00	5.50	6.00	6.31	7.49	8.93	9.72	11.73
EM Local (GBI-EM Australian dollar unhedged)	0%	5%	13%	18%	23%	27%	30%	40%	25%	18%	0%
EM Sovereign (EMBIG Australian dollar hedged)	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%
EM Corporate (CEMBI Australian dollar hedged)	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%
Cash	91%	15%	0%	0%	0%	0%	0%	0%	0%	0%	0%
Australian bonds	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%
Australian corporate bonds	7%	66%	65%	53%	41%	31%	24%	2%	0%	0%	0%
Australian government bonds	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%
Global bonds Australian dollars hedged	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%
Global HY Australian dollars hedged	2%	13%	22%	29%	36%	42%	46%	59%	75%	82%	100%
Global Credit Australian dollars hedged	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%
Global treasuries Australian dollars hedged	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%
EM FI (GBI-EM, EMBIG, CEMBI)	0%	5%	13%	18%	23%	27%	30%	40%	25%	18%	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. Indices used EM Sovereign (EMBIG Australian dollar hedged) – J.P Morgan Emerging Markets Bond Index Global Diversified (EMBIGD) Hedged to AUD; EM Corporate (CEMBI Australian dollar hedged) – J.P Morgan Corporate Emerging Markets Bond Index (CEMBI) Hedged to AUD, EM Local (GBI-EM Australian dollar unhedged) – J.P. Morgan Government Bond Index-Emerging Markets Global Diversified (GBI-EM). Cash – Bloomberg Australian Bank Bill 0+ Yr Index, Global Bonds Australian dollars – Barclays Global Aggregate Bond Index A\$ Hedged, Australian Corporate Bonds – Bloomberg AusBond Corporate 0+ Yr Index, Australian Government Bonds – Bloomberg AusBond Govt 0+ Yr Index, Global HY Australian dollars hedged – Bloomberg Barclay Global High Yield Index A\$ Hedged, Global Credit Australian dollars hedged is Bloomberg Global Aggregate Credit Index hedged into Australian dollars, Global treasuries Australian dollars hedged is Bloomberg Global Aggregate Treasuries Index hedged in Australian dollars. Volatility is Standard Deviation of returns.

It's natural, then, for investors to wonder about risk. The Sharpe ratio combines the return measure with the volatility (risk) measure to quantify the relationship between the returns and risk. The chart below shows the Sharpe ratios for the main fixed income categories and EBND. It's all about HY or EBND. What is surprising is that the asset classes with the worst Sharpe ratios, happen to be dominated by DM and include the largest allocations of many Australian bond portfolios.

Chart 11: 5 years Sharpe ratio, High yield (Australian dollar hedged) and EBND have best Sharpe ratios



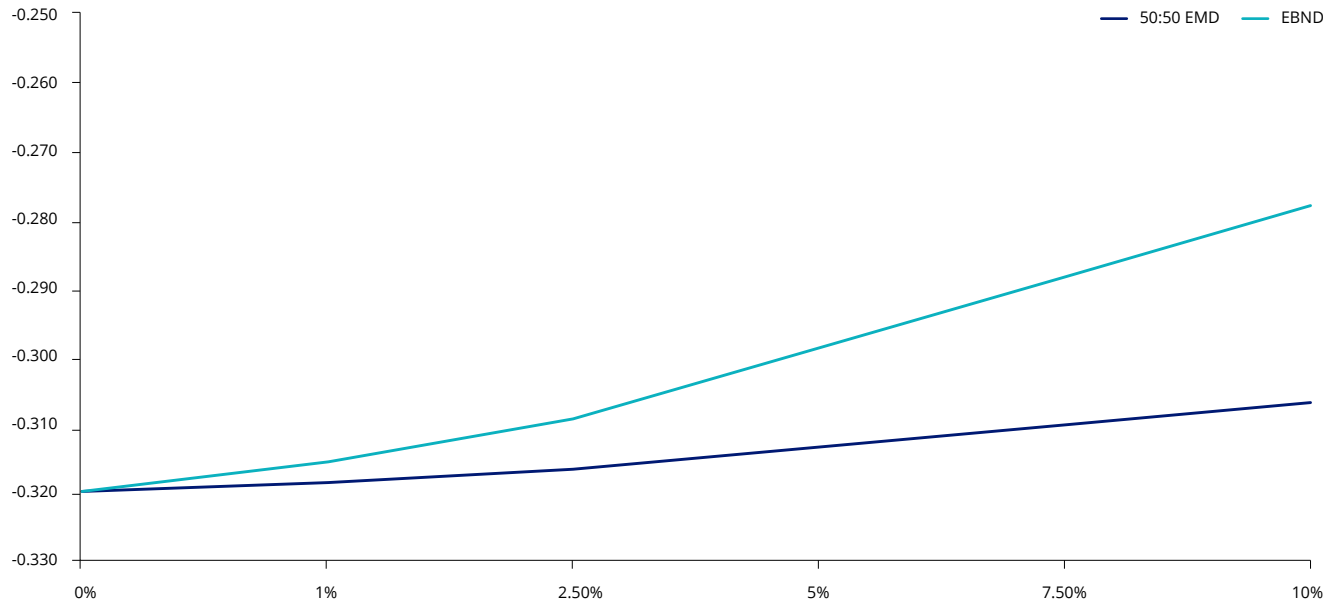
Source: VanEck, Bloomberg to 31 March 2025. Global HY AUD hedged Index is Bloomberg Global High-Yield Index (hedged AUD) Index. CEMBI AUD hedged (US dollar-denominated bonds issued by emerging market corporate entities) is the J.P. Morgan CEMBI Broad Diversified Core Index Hedged AUD. GBI-EM AUD unhedged (local currency bonds issued by emerging markets governments) is J.P. Morgan Government Bond-Emerging Market Index Global Diversified, 50:50 Index is 50% J.P. Morgan Emerging Market Bond Index Global Diversified Hedged AUD and 50% J.P. Morgan Government Bond-Emerging Market Index Global Diversified, Australian bonds is Bloomberg AusBond Composite 0+Y Index, Global bonds AUD hedged is Bloomberg Global Aggregate Hedged to AUD Index, EMBIG AUD hedged (hard currency denominated bonds issued by emerging market governments) is J.P. Morgan Emerging Market Bond Index Global Diversified Hedged AUD. EBND inception date is 11 February 2020.

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Staying within the Australian investor's bond menu, let's look at the same data, showing the change in Sharpe to a portfolio from the addition of EBND's benchmark (50:50 EMD) and EBND to an Australian fixed income portfolio. Let's consider how it changes the Sharpe ratio for each 1% of additional allocation of the benchmark, or EBND, to a fixed income portfolio. You can see that the benchmark is additive, EBND is more so. This is both about EM bonds and their relative attractiveness to DM bonds, as well as the evidence of the alpha achieved by EBND. Alpha can be generated on top of the basic asset allocation decision to just add EM bonds. We think Australian investors' allocations to EM bond strategies that can capture alpha are too low.

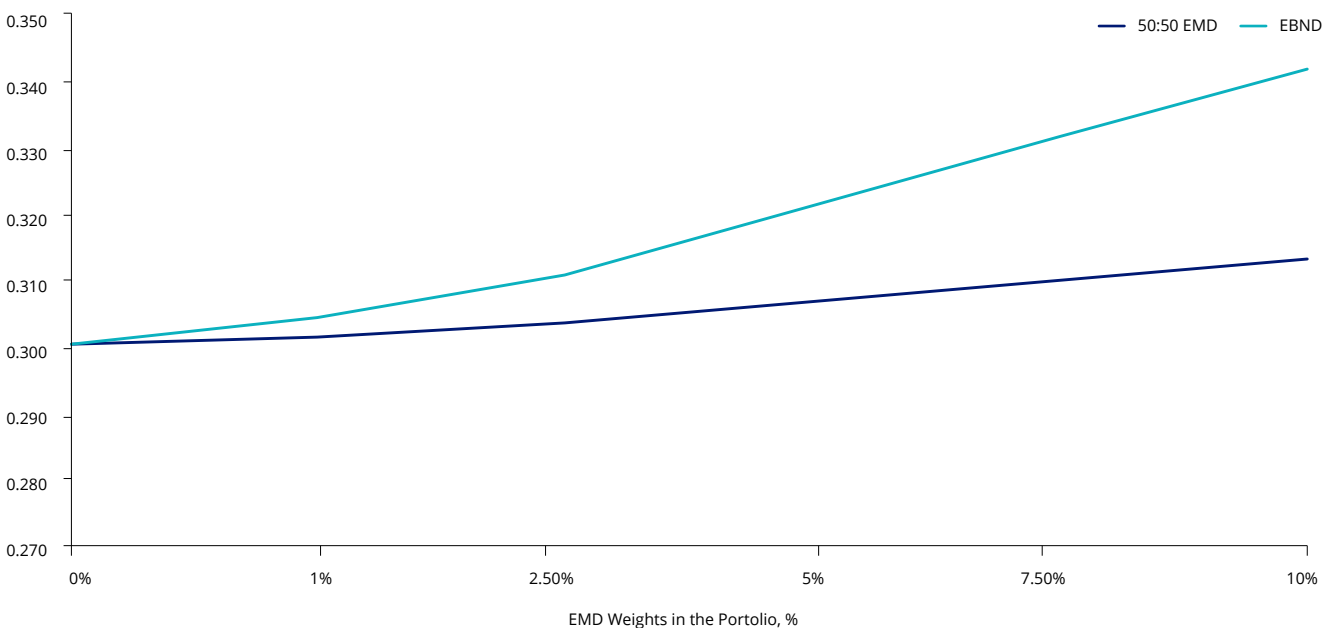
Chart 12: Sharpe ratios after adding EM bonds to an Australian bonds portfolio



Source: VanEck, Bloomberg to 31 March 2025. Past performance 50:50 Index is 50% J.P. Morgan Emerging Market Bond Index Global Diversified Hedged AUD and 50% J.P. Morgan Government Bond-Emerging Market Index Global Diversified, Australian bonds portfolio is represented by Bloomberg AusBond Composite 0+Y Index. EBND performance is calculated net of management costs, calculated daily, but does not include brokerage costs or buy/sell spreads of investing in EBND. Past performance is not a reliable indicator of future performance.

And, for completeness, we have conducted the same exercise but in the complete 60/40 portfolio, for Australian investors. A total portfolio has different correlations. Again, the same conclusion is achieved – the 50/50 EM benchmark increases portfolio Sharpe, and EBND increases it more.

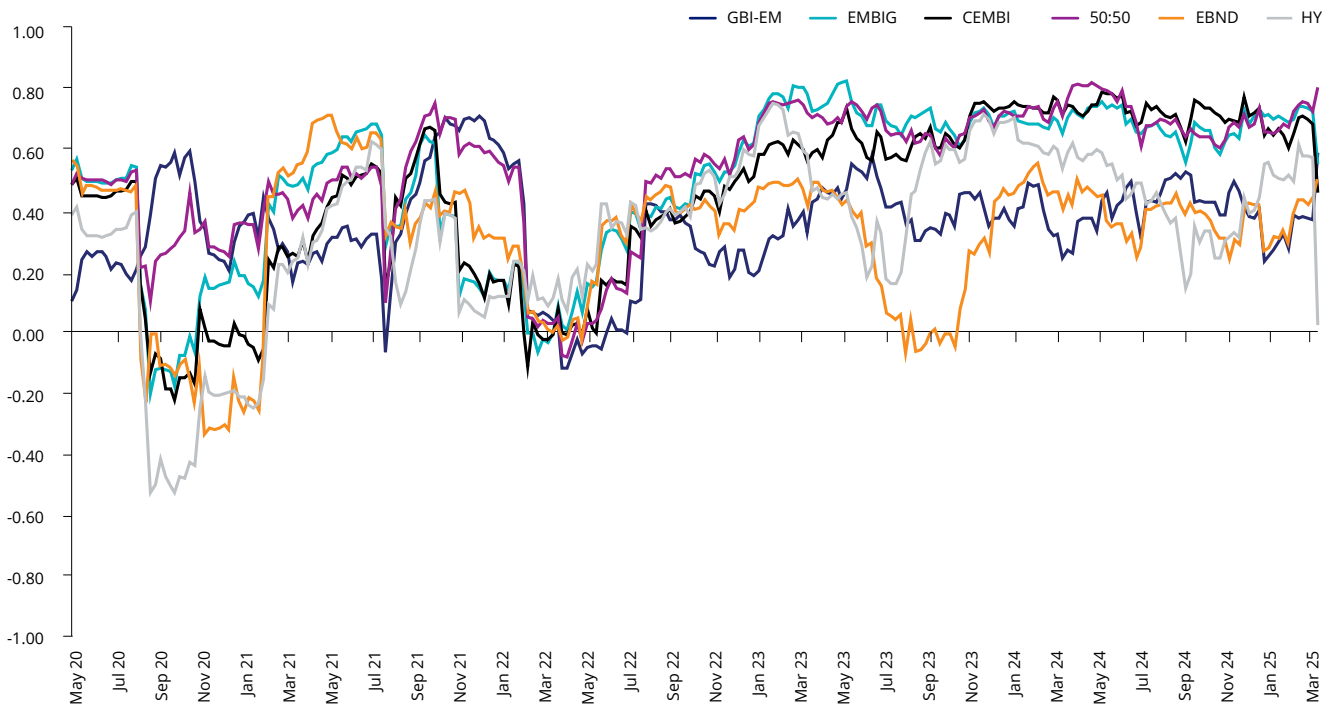
Chart 13: Sharpe ratios after adding EMD to an Australian 60/40 portfolio



Source: VanEck, Bloomberg to 31 March 2025. Past performance 50:50 Index is 50% J.P. Morgan Emerging Market Bond Index Global Diversified Hedged AUD and 50% J.P. Morgan Government Bond-Emerging Market Index Global Diversified, EBND performance is calculated net of management costs, calculated daily, but does not include brokerage costs or buy/sell spreads of investing in EBND. Past performance is not a reliable indicator of future performance. The 60/40 portfolio is 60% S&P/ASX 200 Index, 40% Bloomberg AusBond Composite 0+Y Index.

While the benefits of adding EBND to a portfolio are supported by the above, we think an analysis of correlations provides further support. The few observations we'd make about EBND based on Charts 14 and 15 is that it's correlations with an Australian bond portfolio have been low during the past five years. You will also notice that EBND's correlation with its benchmark is relatively low. Finally, the correlation of HY, relative to Australian fixed income, fluctuates and thus could be considered unstable.

Chart 14: 6 month correlations (based on weekly changes) with Australian bonds



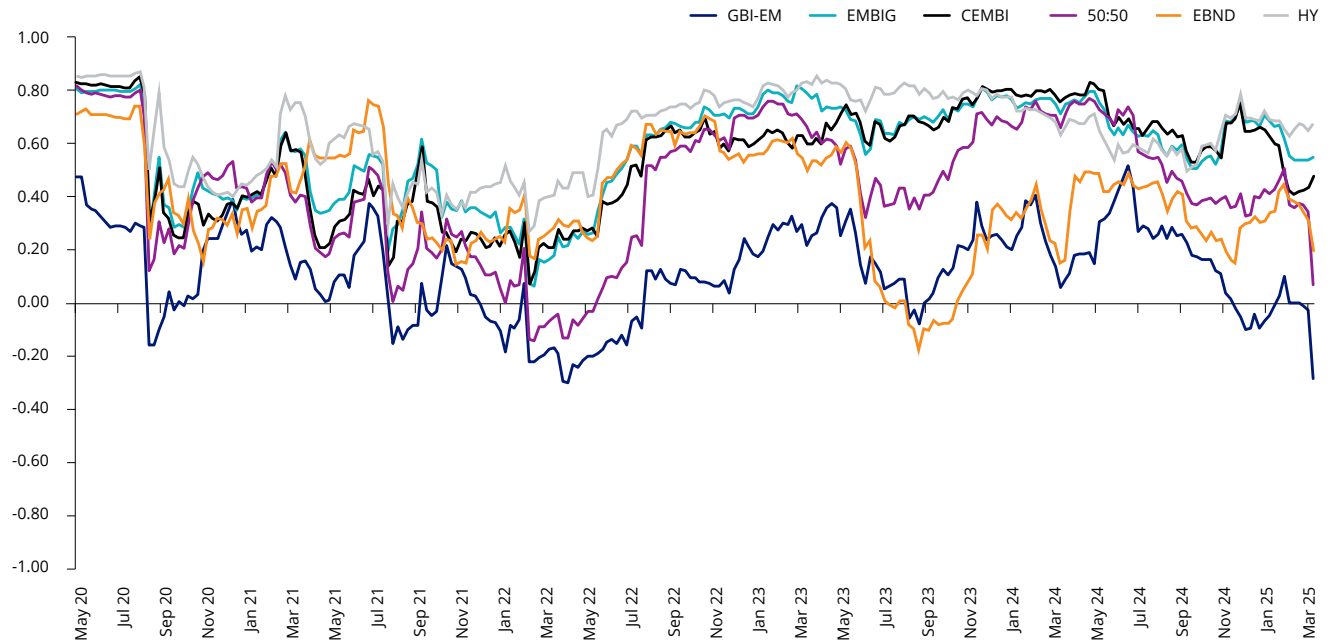
Source: VanEck, Bloomberg to 31 March 2025. Global HY AUD hedged Index is Bloomberg Global High-Yield Index (hedged AUD) Index. CEMBI AUD hedged (US dollar-denominated bonds issued by emerging market corporate entities) is the J.P. Morgan CEMBI Broad Diversified Core Index Hedged AUD. GBI-EM AUD unhedged (local currency bonds issued by emerging markets governments) is J.P. Morgan Government Bond-Emerging Market Index Global Diversified, 50:50 Index is 50% J.P. Morgan Emerging Market Bond Index Global Diversified Hedged AUD and 50% J.P. Morgan Government Bond-Emerging Market Index Global Diversified, Australian bonds is Bloomberg AusBond Composite 0+Y Index, EBND inception date is 11 February 2020.

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And when we consider the correlation with equities, as for a 60:40 portfolio, which we do below, what strikes us is the high correlation between HY and the 60:40 and the low correlation of EBND, its benchmark and GBIEM with the Australian 60:40 portfolio. It could be argued, therefore, EM Bonds and EBND have stronger support for a place in a 60:40 portfolio than they do when you only consider Australian fixed income options.

Chart 15: 6 month correlations (based on weekly changes) with an Australian 60:40 portfolio



Source: VanEck, Bloomberg to 31 March 2025. Global HY AUD hedged Index is Bloomberg Global High-Yield Index (hedged AUD) Index. CEMBI AUD hedged (US dollar-denominated bonds issued by emerging market corporate entities) is the J.P. Morgan CEMBI Broad Diversified Core Index Hedged AUD. GBI-EM AUD unhedged (local currency bonds issued by emerging markets governments) is J.P. Morgan Government Bond-Emerging Market Index Global Diversified, 50:50 Index is 50% J.P. Morgan Emerging Market Bond Index Global Diversified Hedged AUD and 50% J.P. Morgan Government Bond-Emerging Market Index Global Diversified, Australian bonds is Bloomberg AusBond Composite 0+Y Index, EBND inception date is 11 February 2020.

Performance is calculated net of management fees, calculated daily but does not include brokerage costs or buy/sell spreads of investing in EBND. Past performance is not a reliable indicator of future performance.

Bloomberg AusBond Composite 0+Y Index is shown for comparison purposes only and have been selected as they are the widely recognised benchmarks used to measure the performance of developed markets bonds that make up most Australian bond portfolios

We think the key observations of the above analysis of the performance of EM bonds and EBND are as follows:

- Zero is the wrong allocation for EM bonds.
- Over the past five years, EBND has generated alpha relative to its 50:50 benchmark, and this has implications for asset allocators supporting active management.
- EM bonds have the potential to increase Sharpe ratios for Australian fixed income portfolios, but not by as much as the potential for an active approach like EBND.
- HY is more correlated with Australian 60/40 portfolios, and we think HY's performance is, by definition/structure, more a function of the AUD hedge than EBND's.

We think the above justifies the consideration of funding allocations to EM bonds and EBND, with lower allocations to DM bonds that dominate Australian investors' portfolios.

Our investment process

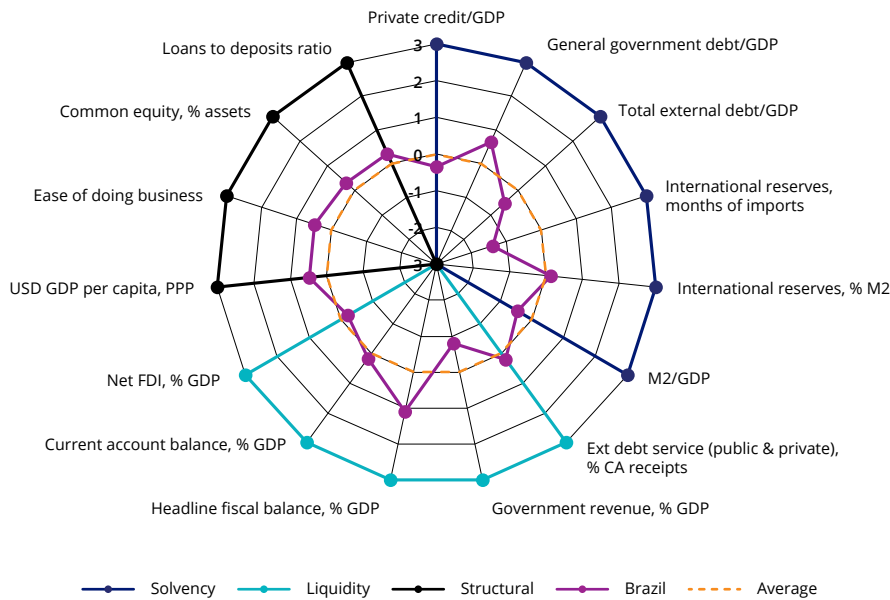
VanEck’s EM bond strategy is valuation-based. Simply, we want to buy cheap bonds, not good or bad risks.

Step 1 of our investment process builds a radar chart showing each country’s superiority, or inferiority, relative to the global average measured in units of standard deviation across a range of 16 fundamental metrics. These metrics include:

- standard measures such as general government debt/GDP,
- flow measures such as the current account deficit/GDP, and
- structural measures such as the banking system’s common equity-to-assets ratio.

We display these as a radar chart, as shown below. When the country result is inside the global mean result, it is superior to the global mean. Conversely, when the result is outside the global mean, it is inferior to the global average.

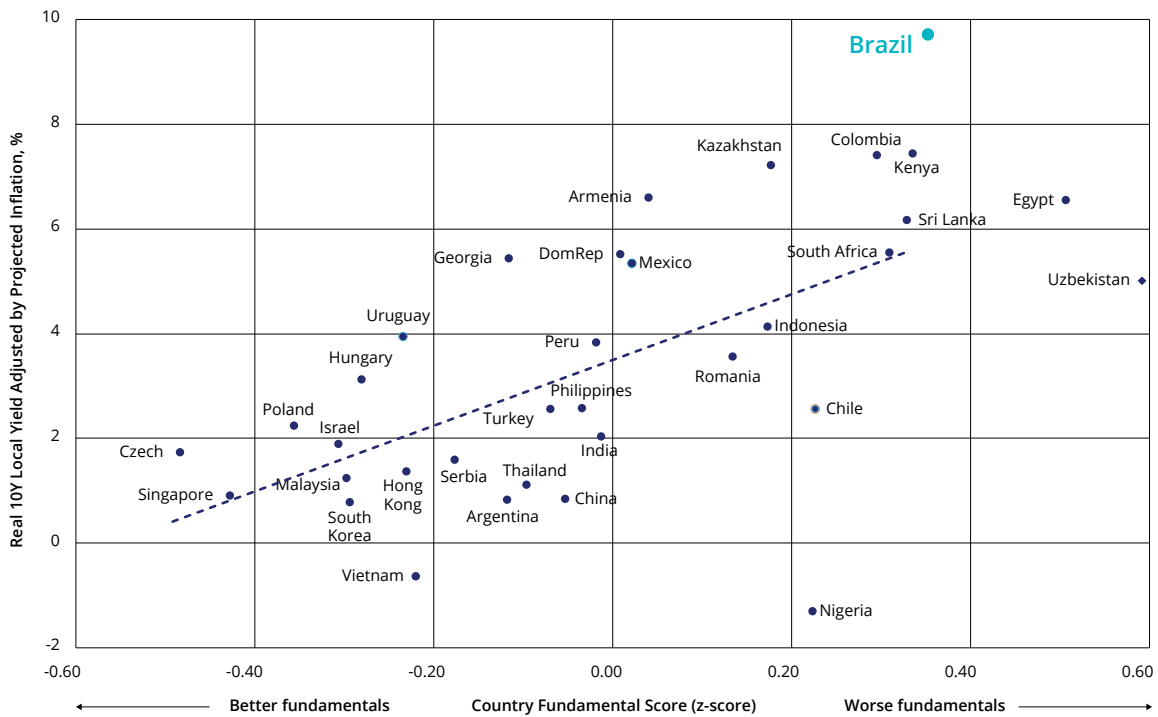
Chart 16: Brazil’s radar chart measuring fundamental risk



Source: VanEck, March 2025.

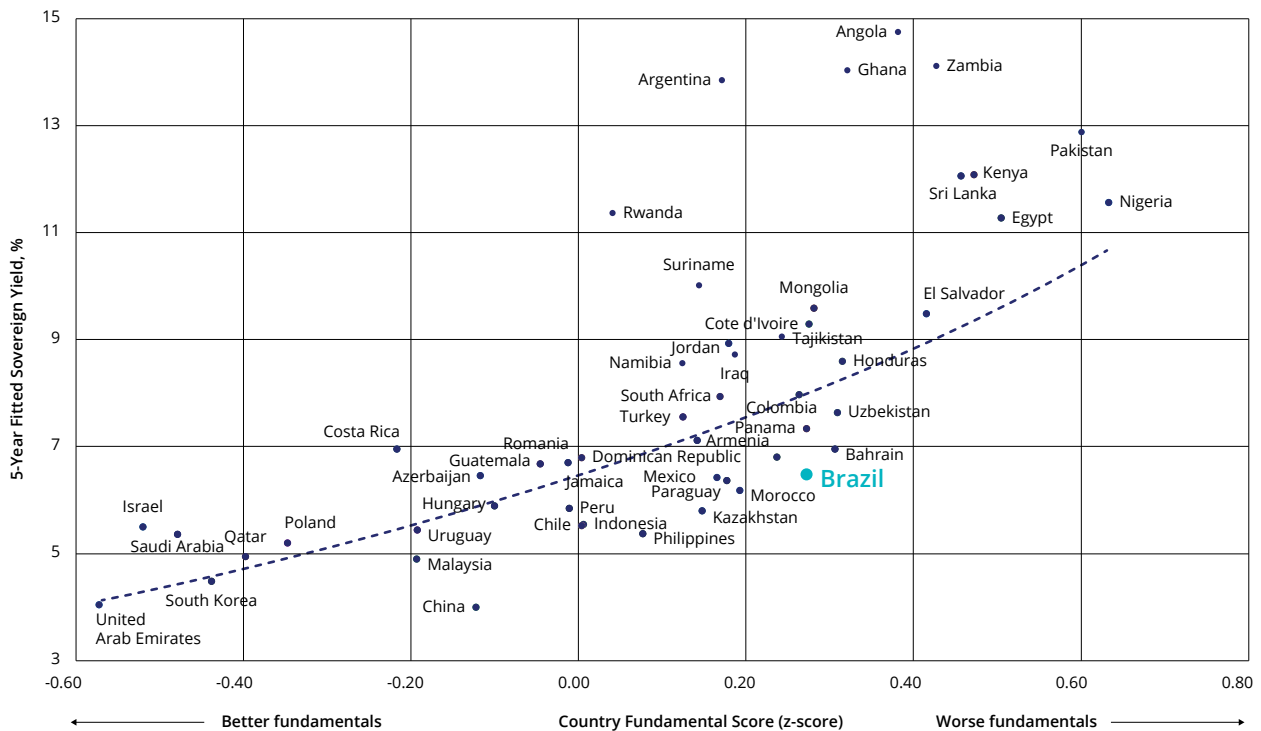
We then “line up” all the radar charts for the countries and companies in the investable universe. We do this by calculating a z-score based on each country’s superiority, or inferiority, to the global mean, as measured by the metrics detailed in the chart. We compare these z-scores and bonds with similar yields. You can see the fundamental z-score on the x-axis in the chart below. Those with superior fundamentals are on the left, inferior to the right. We highlight Brazil and see that the real yields (y-axis) of Brazil’s 10-year local-currency bonds are *higher* than the predicted level (along the dotted line), based on all the other EM 10-year local-currency bonds. They are therefore considered cheap. We conduct this exercise for every tenor of bond. And we conduct it for hard-currency bonds using yield or spread on the y-axis, which you can see in Chart 18. In this chart, you can see that Brazilian hard-currency bonds are *expensive*. The output of Step 1 in our process is a list of the cheapest bonds in EM, whether local, hard, sovereign, or corporate, based *entirely* on their deviation from the predicted level. The cheaper they are, the more they are liked and therefore the higher they are on the list. You may notice that Step 1 favours tenors/duration based entirely on cheapness relative to fundamentals, not the investment teams’ top-down opinion on US ‘duration’. If the 20-year Brazilian local currency bond was cheaper relative to the predicted level than the 10-year Brazilian local currency bond, the 20-year bond is higher in the ranking.

Chart 17: Real 10-year Local currency valuations and country fundamentals determine which 10-year local currency bonds pay real yields that are relatively too high



Source: VanEck, March 2025. Not a recommendation to act.

Chart 18: Sovereign 5-year bond valuations and country fundamentals determine which 5-year hard currency sovereign bonds pay yields that are relatively too high



Source: VanEck, March 2025. Not a recommendation to act.

The result of Step 1 is a list of the cheapest bonds in EM, without reference to whether they are local-currency, hard-currency sovereign, or hard-currency corporate. It is an entirely quantitative process.

In EM, however, there are many non-systematic risks, such as politics, elections, index exclusions/inclusions, global trade partnerships and treaties that are not appropriately managed by the quantitative framework in Step 1.

This is why we have Step 2, which may eliminate or impact the ranking of bonds chosen by Step 1.

Step 2 of the process involves three ‘tests’:

1. political/policy,
2. economic, and
3. technical.

A ‘strong fail’ result on any of these removes a bond from the list. Each test is applied bond-by-bond, so the investment team can fail a 10-year local currency bond from a country but not a 5-year hard-currency bond from the same country. All changes in Step 2 are subjective and documented by the investment team monthly.

Step 3 is portfolio construction. In Step 1, the cheaper a bond is relative to the predicted level, the greater the allocation. If a bond is in the top quartile of cheapness, it gets the maximum allocation of 1.5 times the benchmark weight for that country. If a bond is in the second quartile, the maximum allocation is 1.25 times the benchmark weight for that country and so on, until the portfolio is full.

The portfolio is constructed in consideration of risk constraints.

The case for a blended EM bond approach

The discussion above raises key questions for investors:

- Should I invest in a local-currency only, a hard-currency only or an EM corporate(which is primarily a hard-currency market) only EM bond fund?
- Switch between them or have an even split?

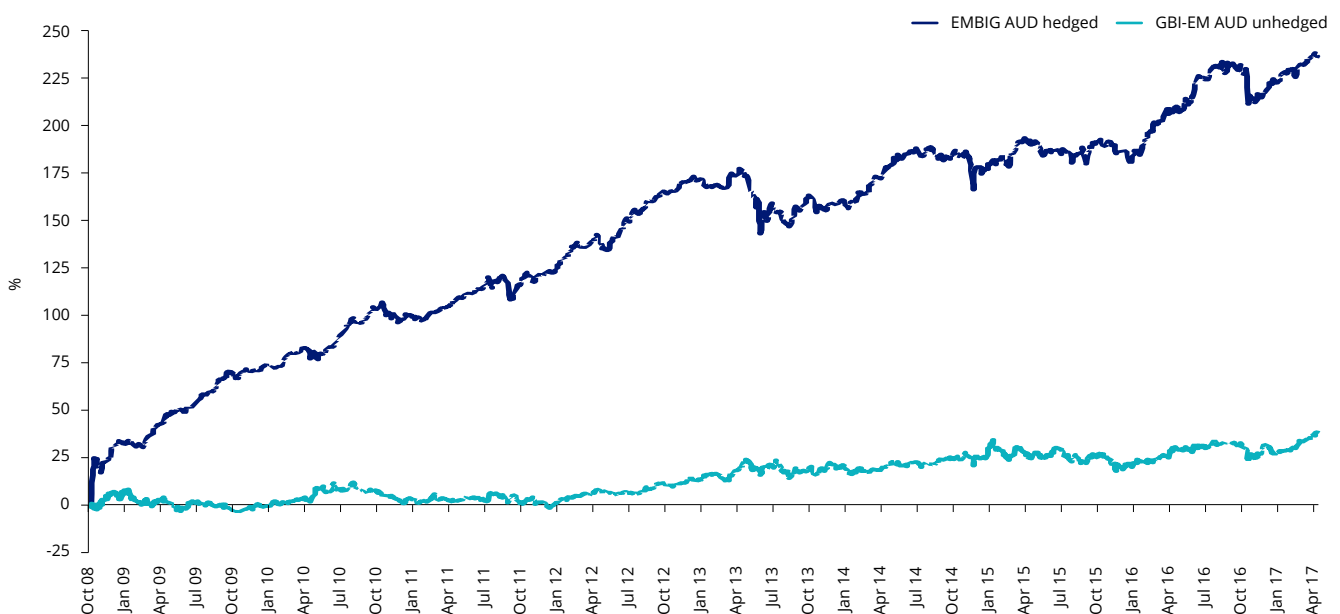
EBND was designed as an investment solution to consider *all* types of EM bonds. In this way, investors could achieve an outcome that was not dependent on the decision between local or hard currency. Local has done better than hard for many years, hard has done better than local for many years, and the investment team's goal is to optimise that over the long term. This allows investors to stay invested in EM bonds and not depend on predicting the type of EM bond that will outperform.

When the team and approach were being established, the seed investor originally wanted a local-currency-only approach because local-currency indices had done well in the three years before the investment being considered. The team, with many years of experience investing in emerging markets suggested an unconstrained blend strategy. And, for most of the 14 years since that investment was made, the team has had the bulk of its exposure to hard-currency bonds, which over that time have outperformed local-currency bonds. Over the past few years, the strategy has been favouring local-currency bonds again.

Most appealing to investors is that the investment process chooses individual bonds on a bottom-up basis, not based on the team's view of top-down considerations like 'the dollar' or 'US rates'.

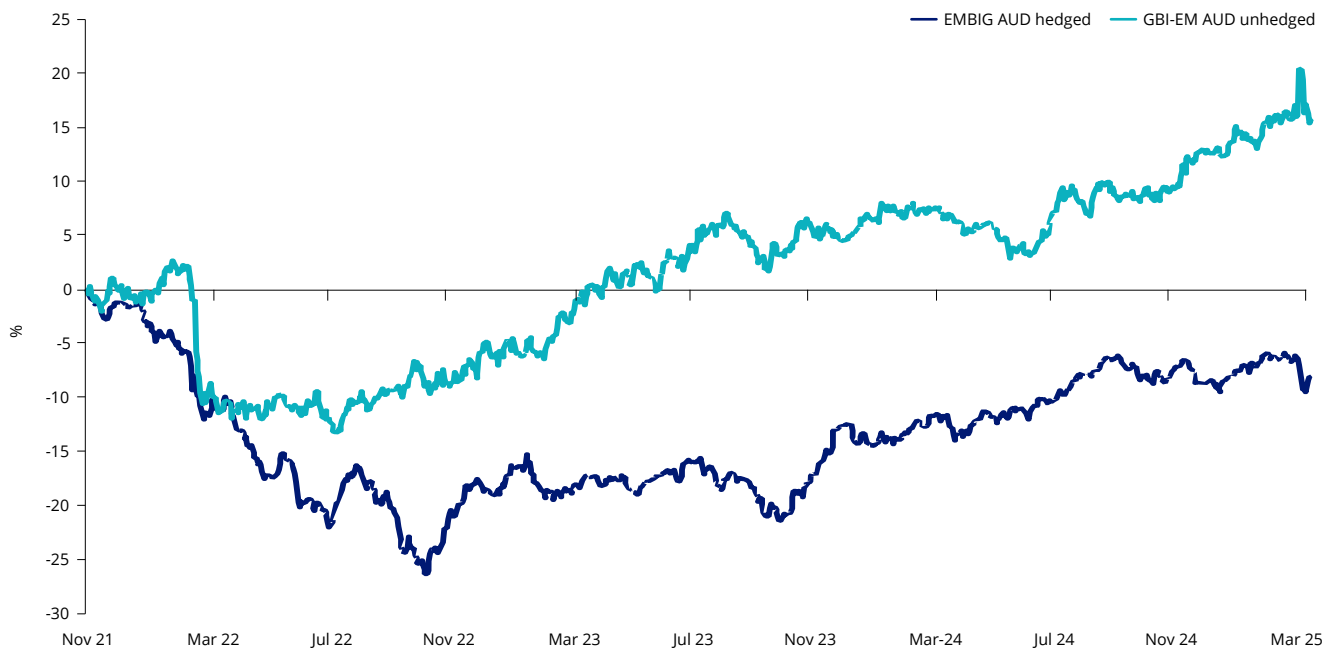
We think an unconstrained, blended approach is the best for many investors because local and hard currency EM bonds can outperform or underperform each other for long periods. Hard-currency EM sovereigns outperformed for almost a decade (2008-2017). More recently, local-currency EM sovereigns outperformed. Investors, including large institutions, that only had hard currency or only local currency bond, therefore, may have had a 'bad' experience with EM bonds. All of their success or failure in EM bonds depended on getting this call right.

Chart 19: Bond Performance EM Sovereign vs. EM Local (total return, %): Hard outperformed local for almost a decade



Source: Bloomberg, EMBIG is J.P. Morgan Emerging Market Bond Index Global Diversified Hedged AUD and GBI-EM is J.P. Morgan Government Bond-Emerging Market Index Global Diversified. Past performance is not a reliable indicator of future performance.

Chart 20: Bond Performance EM Sovereign versus EM Local (total return): more recently local outperformed hard



Source: Bloomberg, EMBIG is J.P. Morgan Emerging Market Bond Index Global Diversified Hedged AUD and GBI-EM is J.P. Morgan Government Bond-Emerging Market Index Global Diversified. Past performance is not a reliable indicator of future performance.

It is useful to look at the complete time horizon, not broken up into specific decades, to get a better view, which we do in the table below. You will hopefully make two observations.

1. We added the Global Aggregate Bond Index to show its underperformance of EM bonds (local and hard). This is one of our key points: don't over-rely on DM
2. Second, more to the point of 'why Blend?', you may notice how our benchmark (50:50) looks compared to only local or only hard. It has never been the worst performer. It's also never been the best. This is another reason we think an approach that allows investors to allocate to all types of EM bonds can generate outperformance.

Table 2: Total annual returns

	Global bonds (AUD hedged)	EM Sovereign (EMBIG AUD hedged)	EM Local (GBI-EM AUD unhedged)	EM 50:50
2004	8.92	15.26	18.19	16.73
2005	6.62	13.18	13.56	13.37
2006	4.41	10.47	7.23	8.85
2007	6.63	7.29	6.02	6.66
2008	9.23	-11.10	19.36	4.13
2009	8.03	30.26	-5.43	12.41
2010	9.28	15.98	1.49	8.74
2011	10.51	12.32	-1.77	5.28
2012	9.66	21.95	15.30	18.62
2013	2.27	-4.83	5.63	0.40
2014	10.37	7.67	3.07	5.37
2015	3.35	3.12	-4.30	-0.59
2016	5.24	11.11	10.47	10.79
2017	3.68	9.89	6.66	8.28
2018	1.65	-4.95	4.20	-0.38
2019	7.19	13.08	13.64	13.36
2020	5.09	4.00	-6.45	-1.22
2021	-1.53	-1.88	-3.15	-2.52
2022	-12.28	-18.03	-5.32	-11.68
2023	5.31	8.20	12.01	10.11
2024	2.23	4.35	7.58	5.96
20 year average	5.04	7.02	5.62	6.32

Source: Bloomberg. Global bonds (AUD hedged) is Bloomberg Global Aggregate Hedged to AUD Index, EM Sovereign (EMBIG AUD hedged) represents hard currency denominated bonds issued by emerging market governments and their performance is measured by the J.P. Morgan Emerging Market Bond Index Global Diversified Hedged AUD, EM Local (GBI-EM AUD unhedged) represents local currency bonds issued by emerging markets governments and their performance is measured by the J.P. Morgan Government Bond-Emerging Market Index Global Diversified. 50:50 Index is 50% J.P. Morgan Emerging Market Bond Index Global Diversified Hedged AUD and 50% J.P. Morgan Government Bond-Emerging Market Index Global Diversified. Past performance is not indicative of future performance. You cannot invest in an index.

The unconstrained, blended approach we take has allowed EBND to navigate significant EM events throughout the five years since its launch on ASX.

How EBND faced three market challenges

The COVID lockdowns

EBND was launched in February of 2020, at the beginning of the COVID-19 lockdowns. In fact, the fund's portfolio manager and economist were on the last flight from Australia to the US following an EBND product launch event. This was a unique period. All markets crashed. The team followed its investment process. Step 1 of the process showed significant numbers of hard-currency sovereign bonds were now extremely cheap. In riskier countries, the subjective judgements in Step 2 of the investment process became more important. The team also observed that the IMF and G-20 launched a series of lending and other facilities for these 'risky' countries, which led to passing grades on the Step 2 tests for many countries. As you can see in the Table 3, 2020 was one of EBND's best years for outperformance.

Table 3: EBND performance as at 31 December 2020

	6 Months (%)	Since EBND inception date# (% p.a.)
EBND	6.74	0.46
50/50 Index	3.03	-3.99
Difference	+3.71	+4.45

Source: VanEck, Morningstar Direct. The 50/50 Index is 50% J.P. Morgan Emerging Market Bond Index Global Diversified Hedged AUD and 50% J.P. Morgan Government Bond-Emerging Market Index Global Diversified.

EBND inception date is 11 February 2020.

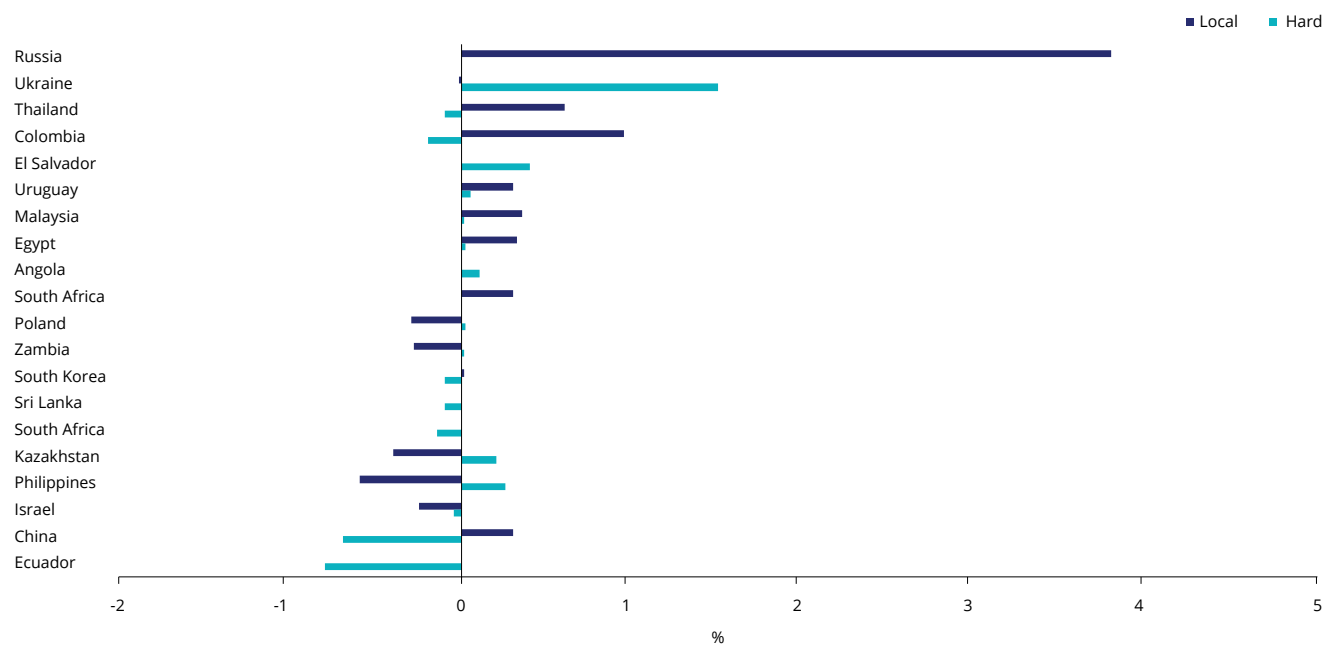
Performance is calculated net of management fees, calculated daily but does not include brokerage costs or buy/sell spreads of investing in EBND. Past performance is not a reliable indicator of future performance.

Russia/Ukraine war

The strategy had no exposure to Russia or Ukraine before the start of hostilities. At the time, many investors were concerned we were missing an opportunity. At the time, the team wrote the explanation for its view and positioning in the fund’s monthly reports. A key response was that the team invested in regional peers, including Georgia, Turkey and Uzbekistan. In the fund’s communications, the team stated Russia was cheap in Step 1 of its investment process, but that Russia was removed due to failing tests in Step 2. In particular, the policy/politics test, due to the risk of war and sanctions, and the technical test, due to the risk of index exclusion.

This crisis highlighted the experience of the EM team. The team had extensive experience with the Crimea and the unfolding crisis. In the early 1990s, the head of the team worked for the US in Moscow, where he built the physical infrastructure onto which SWIFT messaging software was placed. Additionally, he later became a Russia and EMEA economist at Morgan Stanley. This made him attuned to what buy-side portfolio managers were doing, as they were his clients. Unlike many in the market, the team was not reluctant to have a zero position in a big index weight. In the design of the fund, EBND’s strategy specifically allows the team to exclude countries if the team judges that appropriate. During this period of “no Russia or Ukraine”, the team also briefly excluded Turkey and Argentina due to capital control risks.

Chart 21: 2022 contribution to return difference versus the benchmark

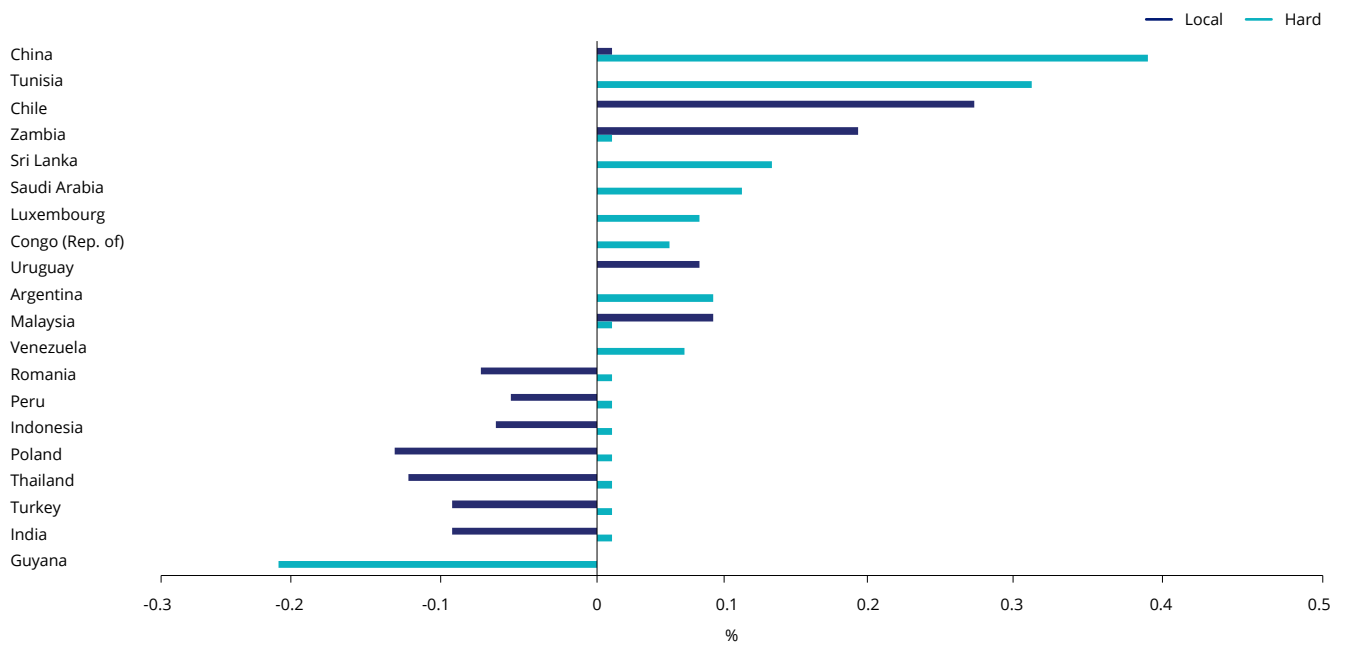


Source: FactSet, VanEck, 1 January 2022 to 31 December 2022. Past performance is not a reliable indicator of future performance.

Chinese property collapse

The strategy had no exposure to Chinese corporate bonds before the collapse because they were not cheap. Remember, most of the property sector was rated investment-grade before the collapse, and given what everyone now knows, those ratings were wrong. Step 1 didn't result in anything cheap among Chinese corporate bonds. So, the selloff phase boosted EBND's relative performance because the fund didn't have any exposure. Following the selloff, though, Step 1 started to find many cheap Chinese property names. Ones that passed the tests of Step 2 were added to the portfolio. That was the second source of outperformance, carefully selected exposure to beaten-up Chinese corporate bonds. We show the under/over performance of the strategy by country for 2025 YTD, as the team remains attracted to this sector.

Chart 22: 2025 Year to date contribution to return difference versus the benchmark



Source: FactSet, VanEck, 1 January 2025 to 31 March 2025. Past performance is not a reliable indicator of future performance.

Appendix 1: Video transcript: Emerging Markets Bonds Then and Now: From Weakness to Resilience, March 2015

The Original Sin: Too Much External Debt

ERIC FINE: In the old days, what led to the EM crises? I define the old days as the 80s and 90s. That was the beginning of the EM debt asset class. Why were there so many crises? The simple reason is: debt composition. Too much dollar-denominated debt. Now, there was a reason behind it. There was low domestic savings and economic policy didn't encourage people to trust governments, banking systems, or central banks in these countries. This was the only market they had access to. The only place they could borrow from was the US financial system. Whatever the reasons—and I do think the reasons were structural in nature—debt composition was mostly dollar-denominated. What does that mean? It means that when you have a crisis that puts pressure on your currency, your ability to repay debt decreases. You're in a vicious circle. Your currency weakens and it's harder for you to repay your dollar debt. Therefore your currency weakens more. It becomes even harder to repay your dollar debt. Thus it was a vicious cycle. Throughout this process that undermined governments' ability to repay debt; governments used their central banks to defend their exchange rate to prevent a deteriorating ability to repay debt. Those efforts were very short-lived. Governments ended up even worse off because they ended up wasting a lot of reserves and still ending up with an inevitable default. It was essentially debt composition at fault because these countries were too dependent on dollar-denominated debt through the US financial system.

The Washington Consensus: Economic and Financial Policy Reforms

FINE: What did emerging economies do to get themselves out of this? Many of them defaulted and reduced their amount of debt. To generalize, you had fiscal adjustments and dramatic reductions in budget deficits. There were structural reforms as well; letting insolvent banks and companies go bust is painful in the short term but healthy in the long term. You had the beginning of far more independent inflation-targeting central banks that would let the exchange rate float, which could be inflationary, but not if you have anchored inflation expectations via good fiscal policy, which is reform number one, essentially. The basic response was fiscal improvements, structural improvements, letting companies and banks default, and forcing restructuring and floating exchange rates, which did not feed through into long-term inflation expectations because fiscal changes anchored them. That was the basic policy response.

Results of EM Reforms

FINE: What's the "so what?" of the Washington Consensus? What did it do to the bond market? Number one is it resulted in higher reserves. Most of your debt is not dollar-denominated. It's mostly domestically-denominated. In domestic currency, you don't need to waste reserves to protect an exchange rate level. You'll thus see reserves in almost all the major EMs increase on a secular basis. That's very practical because it means dollar-denominated debt becomes a much safer asset class. Number two is it generally resulted in higher growth rates. Those were the two biggest implications of the Washington Consensus and the move away from the original sin of having too much dollar-denominated debt.

Global Financial Crisis Taper Tantrum Tests

FINE: What is the proof? How do we know whether this worked? With respect to the '08/'09 crisis, emerging markets were part of the answer. China was able to stimulate, i.e., increase fiscal and monetary stimulus in response to the crisis. In the old days, they'd have to do the exact opposite. They'd have to hunker down and suffer a much worse crisis. A number of the EM countries didn't even go through recession in one of the biggest financial crises in history. That's one general example of this working. The other one is the taper tantrum. The Fed signaled that it was going to end the latest phase of quantitative easing that it had engaged in and the market decided it was worried about countries with large current account deficits: Turkey, South Africa, India, Indonesia, and Brazil. What did all of those countries do? They let their currencies weaken and they let their interest rates rise. Even Argentina did that. That is not good if you own those currencies or those local currency bonds. If you own duration in local or if you own the currency, that's not good. However, if you owned dollar-denominated bonds, that was good. Moreover, weakening your currency and hiking interest rates directly addresses the current account deficit. All of a sudden, they weren't afraid of letting their currencies weaken because it wasn't going to turn into a vicious debt cycle. It would actually address the specific problem. Those to me are the two best examples of what this new policy framework means for emerging markets bonds.





This video is available at www.vaneck.com/ie/en/videos/em-bonds-then-and-now-weakness-to-resilience

Key risks

An investment in EBND carries risks associated with: ASX trading time differences, emerging markets bonds and currencies, bond markets generally, interest rate movements, issuer default, currency hedging, credit ratings, country and issuer concentration, liquidity, fund manager and fund operations. See the VanEck Emerging Income Opportunities Active ETF PDS and TMD for more details.

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