HEALTH WEALTH CAREER

REVISITING EMERGING MARKET DEBT

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EXECUTIVE SUMMARY

- Many institutional investors introduced allocations to local currency emerging market debt (LC EMD) in the years following the global financial crisis as part of an attempt to diversify the sources of return in their growth portfolios. Falling equity and bond markets across the emerging markets universe have tested the resolve of investors in these markets in recent years, with the scale of drawdowns experienced arguably greater than many would have expected at the outset.

- We continue to support investment in emerging markets as part of a diversified global approach, as the size of these markets makes them impossible to ignore. This paper reviews experience to date in emerging market debt and considers the range of approaches to accessing these markets for investors with differing time horizons and tolerance for volatility.

- Though we expect LC EMD to deliver attractive total returns over the long term, we recognise that the asset class is susceptible to periods of high volatility, driven in large part by the movement of EM currencies (themselves driven by changing economic fundamentals and market sentiment). For investors with a lower risk tolerance and/or a shorter time horizon, we believe "total return" approaches merit consideration. The return profile of such strategies would typically exhibit lower volatility, offer access to a broader opportunity set, and be driven to a greater extent by manager skill (or "alpha").

- Total return EMD managers adopt a more outcome-driven approach than a benchmark-relative approach to investing. This leaves them free to select their highest conviction ideas, typically from the full spectrum of EM fixed-income opportunities, including local currency sovereign, hard currency sovereign, and hard currency corporate bonds. Some may also access local currency corporates and frontier markets. Note that the degree of focus within each of these assets may vary from manager to manager depending on their areas of expertise.

- One of the key differentiating features of total return strategies is that these managers can tilt their portfolios dynamically to reflect their best ideas in a way not driven by any particular market benchmark. As a result, the return profile should be driven more by "alpha" (manager skill) and less by "beta" (market returns) than a traditional EMD mandate. This is also a source of risk, as the total return approach places greater emphasis on manager skill and the ability to access the right assets at the right time.

BACKGROUND

Emerging market debt (EMD) describes both government and corporate debt issued by borrowers in emerging markets and can be issued in hard currency (for example, US dollar, euro) or local currency (the domestic currency of the issuer). Many institutional investors added LC EMD allocations to their portfolios following the 2008 financial crisis to seek a better diversified growth portfolio and a potential reduction in overall volatility (relative to equities). However, falling equity and bond markets across the emerging markets have led to meaningful drawdowns within LC EMD, driven principally by emerging market currency depreciation. (Further details regarding the experience of the asset class to date and associated risks will be explored in the next section.)

Despite these drawbacks, Mercer supports emerging market investment as part of a diversified global portfolio, and we believe LC EMD has the potential to deliver attractive total returns over the longer term. This view is predicated on the increasing significance of the emerging markets as well as the attractive (and diversifying) characteristics offered by many emerging economies.

An important aspect of EM growth dynamics is the possibility for significant productivity gains due to improvements in infrastructure, equipment, and labour force upskilling. Many EM economies are also exposed to demographic tailwinds driven by younger populations (relative to much of the developed world) that are expected to contribute positively to labour force and economic growth. From a debt perspective, a number of key emerging economies also enjoy lower levels of government debt and stronger fiscal positions than their developed market counterparts, which should allow them to better withstand unexpected rises in debt servicing costs.[1]

> Although growth dynamics are attractive, some investors cannot tolerate the associated volatility and drawdown potential of local currency emerging market debts.

At the same time, we recognise that some investors cannot tolerate the associated volatility and drawdown potential of the LC EMD asset class. Therefore, the second part of this paper will discuss an approach for those investors that are not willing or able to withstand the volatility of a dedicated LC EMD mandate and/or have a shorter investment horizon, but would still like to be exposed to the broader emerging market debt opportunity set.

RECENT MARKET DEVELOPMENTS AND RISK FACTORS

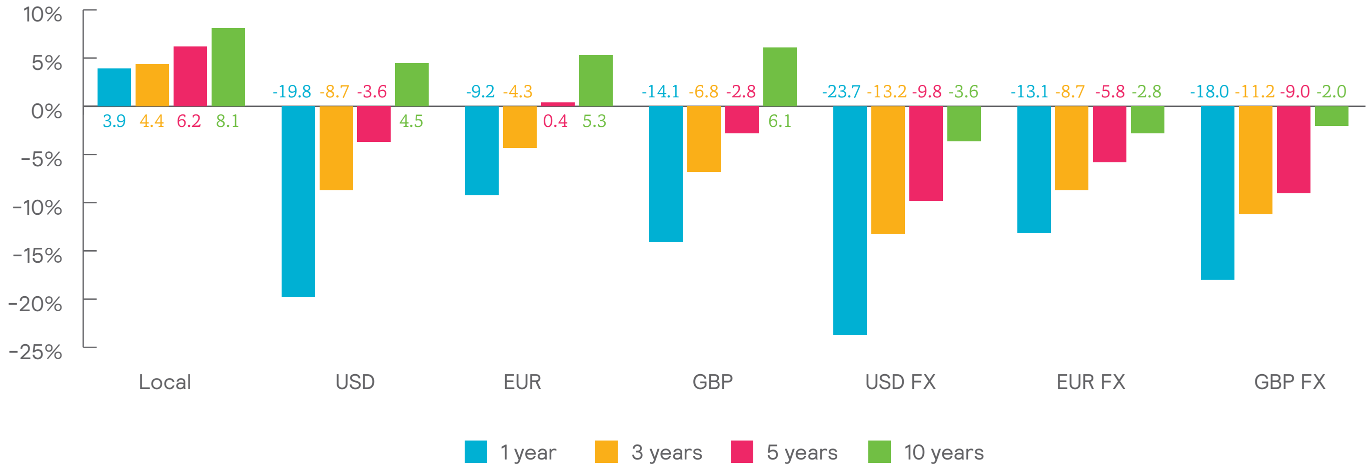
In recent years, a series of headline events has added volatility to the LC EMD asset class, primarily driven by currency volatility. The first of these major headline events came during the "taper tantrum" in the summer of 2013, when markets feared the US Federal Reserve (the Fed) would raise rates. This resulted in deteriorating sentiment and reduced global risk appetite, leading to outflows from the asset class and broad-based EM currency depreciation. In the summer of 2014, tensions between Russia and Ukraine escalated, leading to a significant weakening of the Russian rouble and sending bond yields markedly higher. The severity of the fall was reflected in the observation that at the end of 2013, Russia represented just under a 10% allocation in the benchmark index and is currently around just 5% (source: JPMorgan as at 30 September 2015).

More recently, fears of a slowdown in China and the associated staged devaluation of the Chinese yuan, together with falling commodity prices, have further weakened EM currencies. The significant effect of the currency depreciation can be seen in Exhibit 1. In particular, this chart demonstrates that the negative performance within the asset class has been driven almost solely by currency depreciation. For example, the one-year currency return alone to 30 September 2015 of a basket of EM currencies relative to the US dollar was -24%, and -18% relative to sterling.

[1] We have not attempted to set out a wholesale reassessment of the case for emerging market exposure in this paper.

EXHIBIT 1

LC EMD TOTAL AND FX RETURNS TO 30 SEPTEMBER 2015



Source: Thomson Reuters Datastream

In contrast, the exhibit demonstrates that the return from the local bond component has actually been positive over the last 1, 3, 5, and 10 years, illustrating that emerging market bonds are ultimately income-producing assets.

In addition, many EM countries are significantly exposed to commodity demand or other associated export demand, making them susceptible to economic conditions in China, North America, and Western Europe. Arguably, however, there are just as many commodity net importers in the EM universe; thus, the overall impact of commodity weakness is more mixed than many headlines imply.

Critically, investors fear market moves can create a vicious cycle whereby bad economic news results in portfolio flows away from a country's bond and equity markets, resulting in a weaker currency. This can heighten inflation and cause the central bank to interject to protect the currency, typically by raising rates, potentially constraining growth and worsening economic difficulties, as has been seen recently in both Russia and Brazil.

Given the above, although we believe LC EMD can offer attractive returns in the long run, we recognise that there are a number of important risk factors for LC EMD investors in the near to medium term that may continue to lead to negative returns and/or increased volatility.

These risks include:

- Commodity weakness and China slowdown:
  - Some EM countries are materially exposed to a weakening in commodity prices.
  - Likewise, some economies are heavily exposed to a China slowdown.

- But some countries are net importers of commodities and will benefit from lower commodity prices, and not all are materially exposed to the weakness in the Chinese economy.
- However, this may not prevent the whole market trading lower, as increased volatility may lead to a contagion effect in markets.

- Fed lift-off:
  - We do not expect a repeat of the "taper tantrum," because the Fed has attempted to limit the prospect for surprising the market by sending clear and timely announcements on the future path of interest rates. However, despite the Fed's best efforts, the risk remains that emerging markets may suffer a disproportionately negative effect when the Fed begins raising rates. This includes the potential negative effect of a strengthening dollar for emerging market currencies.
- Idiosyncratic:
  - Each EM country poses its own political/ geopolitical, social, and economic risks that drive the risk of capital impairment via currency depreciation, interest rate movements, or default. Recent events in Brazil (now in recession) and Turkey (political) reinforce these risks.

MANAGER PERFORMANCE REVIEW AND ACCESSING LC EMD MANAGERS

We believe the diversity, breadth, and complexity of the emerging market universe (both in equity and debt) create a case for genuinely active investment approaches. However, in recent years, we've observed that the median tracking error (a measure of a manager's deviation against its benchmark) in the Mercer LC EMD universe has been falling. This has been driven in part by higher intramarket correlations, causing less dispersion in returns between countries. Undoubtedly, this is also a function of some managers in the universe choosing to take less active risk than they did in the past. Indeed, relative returns (alpha) within the universe have also been subdued, with the median manager delivering 0.3% pa alpha over the last five years and the upper-quartile manager delivering alpha of 0.9% pa (figures gross of fees).

> In recent years, the median tracking has been falling, driven in part by higher intramarket correlations, causing less dispersion in returns between countries.

Based on our conversations with managers, we believe one of the key drivers of disappointing alpha levels (relative to typical target of 2%) has been the risk-on/risk-off environment driven by significant shifts in sentiment. Most managers have now evolved their investment process to better capture shorter-term factors, and this is starting to appear in more recent returns for the most capable managers, with the upper-quartile manager delivering alpha of 1.4% over one year to 30 September 2015. (The median manager delivered 0.1% below the benchmark over the same period.)

It's important to distinguish between benchmark-driven and benchmark-aware managers within the LC EMD universe. Benchmark-driven managers

tend to take a broad range of small active decisions relative to the benchmark and are unlikely to take any meaningful positions relative to benchmark when it comes to their overall duration, country, or currency exposure. Such managers tend to exhibit lower tracking errors over time as a function of this approach. In contrast, benchmark-aware managers are typically willing to take larger active positions. These managers tend to exhibit higher tracking errors through off-benchmark allocations (for example, in developed-market currencies, which can have a material effect on measures of active risk).

For those long-term investors that wish to stay invested in dedicated LC EMD mandates, we continue to see merit in both styles of manager and would stress that the decision to allocate to one style over the other will be dependent on investor risk tolerance and preferences. However, we also believe investors may benefit by diversifying across both styles of manager in order to reduce manager risk and to access complementary investment approaches.

Ultimately, we recognise that for investors with a shorter time horizon and/or a lower risk tolerance, even the most active (relative to the benchmark) LC EMD managers might not deliver the lower-volatility return profile desired. Thus, we believe there is an alternative approach that could complement and/or replace a dedicated LC EMD allocation and help deliver a lower-volatility return profile that seeks to achieve a healthy level of return over meaningful time periods. This alternative approach is called "total return."

UNDERSTANDING THE BROADER EMERGING MARKET DEBT UNIVERSE

Before providing more detail about the total return approach to EMD investing, we think it's useful to provide an overview of the historical characteristics within the emerging market universe to set the scene.

Exhibit 2 shows the characteristics of the three flagship JPM EMD benchmark indices as at 30 September 2015.

EXHIBIT 2

	JPM GBI EM GD LC EMD	JPM EMBI GD HC EMD	JPM CEMBI D HC CORPORATE EMD
Yield	7.1	6.3	6.2
Duration	4.9	6.6	5.4
Average Credit Quality	BBB+	BB+	BBB
% Investment Grade	79	58	65
10-Year Returns	4.5	6.9	6.5
10-Year Volatility	12.8	8.8	10.1
Returns/Volatility	0.3	0.8	0.6

Source: JPM. Returns in US dollars.

Over the last 10 years, HC EMD has exhibited about 70% of the volatility of LC EMD, whereas HC corporate EMD has exhibited about 80% of the volatility. The returns of both hard currency markets are heavily dependent on US interest rates because of their US duration component (and this has been a big driver of returns over the last 10 years). In addition, both markets are highly correlated to US credit spreads. Therefore, the opportunity set tends to trade more as a reflection of movements in developed markets than in emerging markets.

From a credit quality perspective, the hard currency markets exhibit a lower credit quality than LC EMD. One reason is that countries or companies generally issue in hard currency debt when they cannot issue in local currency debt — often because they're at a less advanced stage economically compared to their peers in the local currency benchmark. As their economies and companies develop, their credit quality improves and they tend to shift their issuance patterns towards local currency.

However, this isn't to say that there aren't attractive opportunities within the hard currency universe. There should always be pockets of value, and we believe there are EMD managers who have the capability to look across the entire EMD spectrum to find the best opportunities. Our preferred approach is for managers to do this in an unconstrained way with limited anchoring to any specific benchmark. The benefits and drawbacks of this total return approach are explored below.

AN INTRODUCTION TO TOTAL RETURN EMERGING MARKET DEBT

Total return investing involves adopting an unconstrained approach to accessing the EMD opportunity set. The term "unconstrained" refers to the process of selecting assets as well as the opportunity set. With respect to the process, total return managers are free from the constraints of investing against a market cap benchmark or even a blended benchmark. Instead, the starting point is selecting only those assets that represent their highest total return ideas. This is often considered in the context of a preset volatility (as opposed to tracking error) budget. From an opportunity set perspective, "unconstrained" refers to the fact that managers will typically access hard currency sovereign EMD, hard currency corporate EMD, and LC EMD. Some managers also access frontier markets.

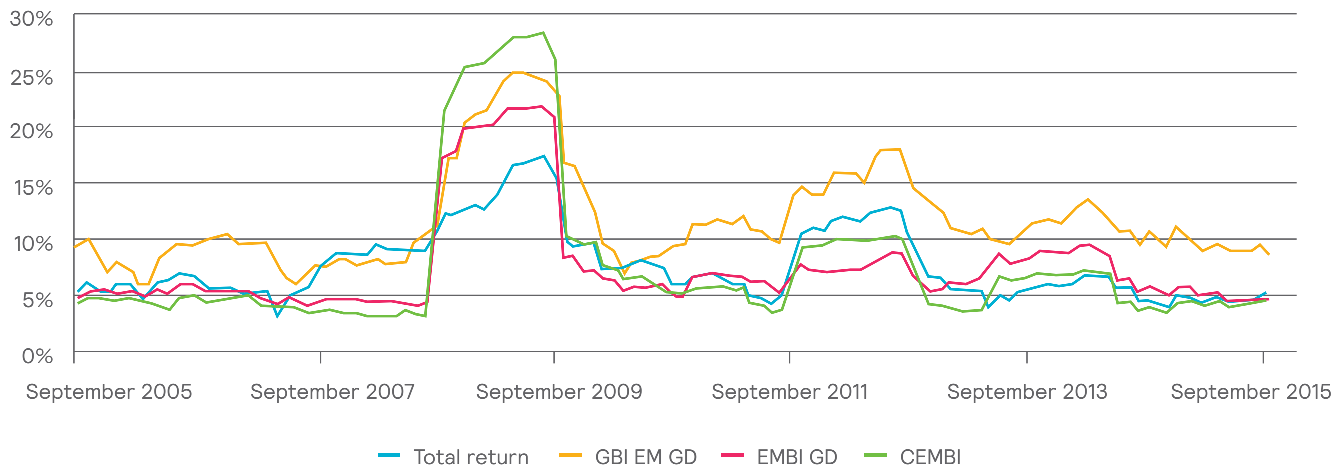
> Total return investing involves adopting an unconstrained approach to accessing the EMD opportunity set.

With access to a broader opportunity set, there are greater opportunities for managers to generate potentially attractive returns, as well as to diversify across different risk factors, including duration risk, credit risk, and currency risk. As the hard currency universe comprises a much higher number of sovereign issuers and as there is considerable name diversity in the corporate universe, total return mandates have scope to deliver improved issuer diversification relative to a standalone LC EMD mandate, but not necessarily versus hard currency

benchmarks. We believe the combination of a more dynamic approach to managing beta (including EM FX exposure) and better diversified portfolios should lead to total return strategies delivering, on average, a lower-volatility outcome than pure local currency EMD mandates.

Exhibit 3 shows the rolling standard deviation of one-year returns of the median manager in the total return universe and each of the EMD betas (or market segments). It shows that LC EMD volatility has been persistently above that of HC sovereign and HC corporate EMD. However, it's worth noting that during the global financial crisis, HC corporate EMD exhibited more volatility than LC EMD due to a high level of defaults, whereas total return strategies exhibited considerably less volatility than LC EMD and similar volatility to the hard currency beta indices. We believe this illustrates the diversification benefits of total return strategies and the impact of providing a manager with a mandate to select only their highest-conviction ideas (which could include the reduction of market risk, if desired).

EXHIBIT 3
ROLLING ONE-YEAR VOLATILITY (USD)



It's important to highlight that total return EMD managers are not absolute return managers. They're expected to retain a high degree of market exposure most of the time. Thus, in the event that EMD sells off across the board, they remain susceptible to negative returns. Over time, we would expect total return strategies to capture a good level of the upside while helping reduce some of the downside risk associated with EMD exposure.

However, investors should recognise a number of important characteristics, risks, and limitations of total return approaches.

First, such strategies rely more heavily on manager skill as a driver of return. Portfolios should comprise only a manager's highest-conviction ideas, which requires a greater reliance on the manager's ability to consistently generate good ideas and implement them in a sufficiently diversified way. This also requires a greater reliance on the manager's ability to rotate between the best opportunities on both a bottom-up and top-down basis (across the sub-sectors).

Second, the liquidity of a total return mandate can be expected to be slightly less than that of a dedicated LC EMD fund. LC EMD is one of the more liquid segments of the market, and at the opposite end of the liquidity spectrum is HC corporate EMD, with HC sovereign EMD somewhere in between. This is due in part to the size of the respective markets as well as the number of active investors in these universes.

Third, assessing the performance of such managers becomes more challenging in the absence of a market benchmark. As individual managers typically have different objectives, peer group comparison is less effective. Ultimately, we believe managers should be judged against the objectives they have individually set. This is typically a total return or cash plus objective and may include a volatility range or target.

Another possibility is to focus on Sharpe ratios (essentially a measure of return per unit of risk or volatility). We believe total return investing has the potential to deliver better risk-adjusted returns than a simple blended benchmark of EMD market exposures. However, few managers set such an objective because it would alter the starting point of their investment process to be driven by the benchmark, which is the very thing we're trying to move away from. Furthermore, the benchmark is likely to differ between managers, as each may have a different bias, reflecting their total return and/or risk objectives.

It's also worth highlighting that the total return universe is relatively new. This is because the number of total return strategies has really only grown materially in the last two to three years as managers have recognised the need and demand for this type of approach over and above dedicated single-beta mandates or blended mandates. The Mercer manager research team is continuing to build out the universe. We believe this development mirrors that which has already materialised in broader credit mandates whereby managers adopt an unconstrained approach across the various credit sectors (for example, multi-asset credit strategies). We remain supportive of such approaches from a portfolio construction perspective and believe portfolios that are more biased towards alpha (manager skill) are better-placed to deliver returns in the current environment.

For those investors seeking to diversify from a dedicated LC EMD allocation that are unable to get comfortable with the more unconstrained nature of a total return mandate, a blended benchmark mandate may be more appropriate. This offers the benefit of a relatively fixed beta exposure, which is agreed in advance and is less dependent on manager skill (relatively speaking). The drawback is that asset allocation shifts between the different components of the benchmark may be more limited given the anchoring effect of a blended benchmark.

CONCLUSION

For long-term investors with a moderate to high tolerance for volatility, we believe LC EMD has the potential to deliver attractive total returns in the long run. However, for investors with a lower risk tolerance and/or a shorter time horizon, we believe total return approaches merit consideration. Such strategies are expected to exhibit lower volatility, offer access to a broader opportunity set, and be more reliant on manager skill as a driver of return than traditional LC EMD mandates. For investors with the requisite governance budget, we believe total return approaches can offer an attractive complement to existing local currency EMD allocations.

For long-term investors with a moderate to high tolerance for volatility, LC EMD has the potential to deliver attractive total returns in the long run.

Investors with a lower risk tolerance and/or a shorter time horizon should consider total return approaches.

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