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EMERGING MARKETS BONDS

PUTTING ON A SPREAD

Over the past 10 years, few investments have provided the kind of returns available from emerging markets debt. And if investors keep an eye on yield spreads, this asset class won't have to turn into just another over-hyped story

Emerging markets bonds are witnessing their strongest inflows since 1995. According to emerging-portfolio.com, which tracks 168 emerging market debt funds holding assets of $10bn, $1.2bn (€1bn) in new money flowed in during the first three months of 2003, representing a 14 per cent increase on the previous year.

Investors can choose from bonds issued by more than 50 emerging economies, starting with Argentina and moving alphabetically through Bulgaria, Malaysia and Tunisia to Venezuela. These sovereign bonds, generally rated BB or below, have a higher risk of default than investment grade corporate bonds. As compensation for the higher default risk, they have a higher yield. Currently, emerging market bonds are yielding an average of 10 per cent (as measured by the EMBI), compared with between 3 and 5 per cent for US Treasuries.

As an asset class, emerging debt has matured over the last 10 years. It has grown in assets, issues, investor base and number of countries in the universe. The market is currently worth $260bn, mainly in dollar-denominated bonds. The popularity of this asset class is down to equity-like returns, which are uncorrelated to the equity markets. According to JPMorgan, emerging market bonds have had a negative correlation with equities over the last three years, and just 0.54 with the S&P 500 over 10 years.

RETURNS

If we compare the JP Morgan Emerging Markets Bond Index (EMBI Global) to the S&P 500 index, we see that from 1995 to 2000, emerging markets debt has risen roughly in line with equities. But since then, the equity market has fallen, losing three years of returns, while emerging markets debt has returned 215 per cent over eight years (as per April 30, 2003).

Private investors need to allocate funds over a broad variety of asset classes, distinguishing between growth and equity-oriented investments. But today's low interest rates, and equity markets which move almost in unison, lead them to face a huge dilemma. Investors can either put money into income-related products, which earn very little, or growth products, which are so interrelated, that they take you through all the swings of an economic cycle.

As bonds, which behave like an equity asset class, emerging market debt answers this need for diversification of growth related investments.

Examining the Markowitz efficient portfolio frontier for the JP Morgan EMBI Global plotted against the S&P 500,

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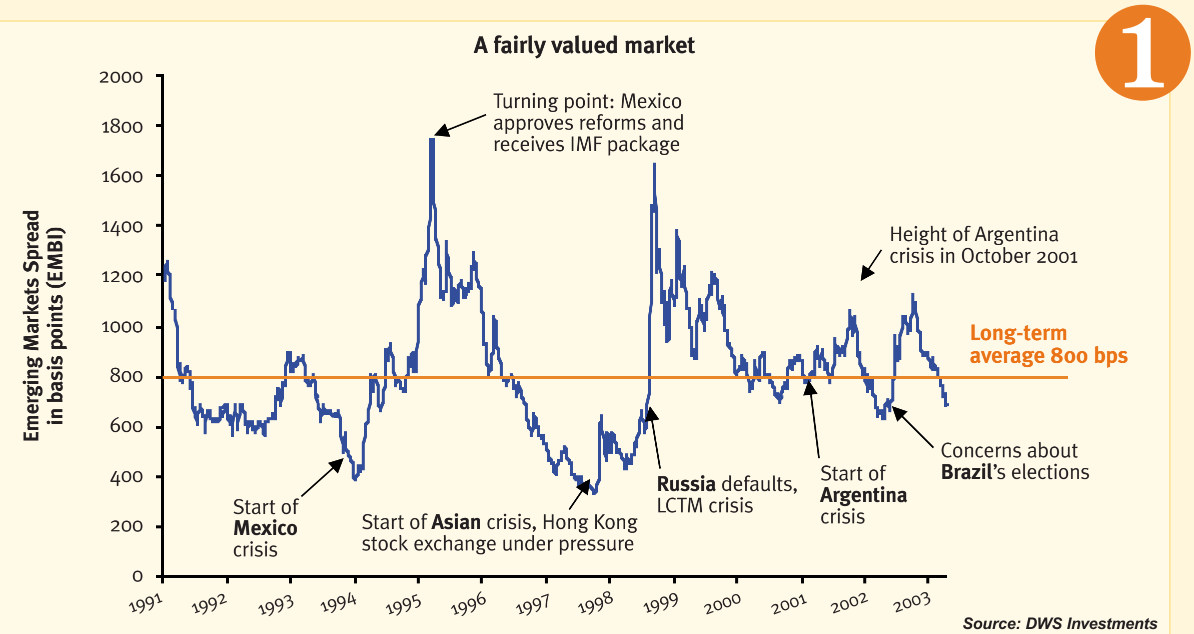
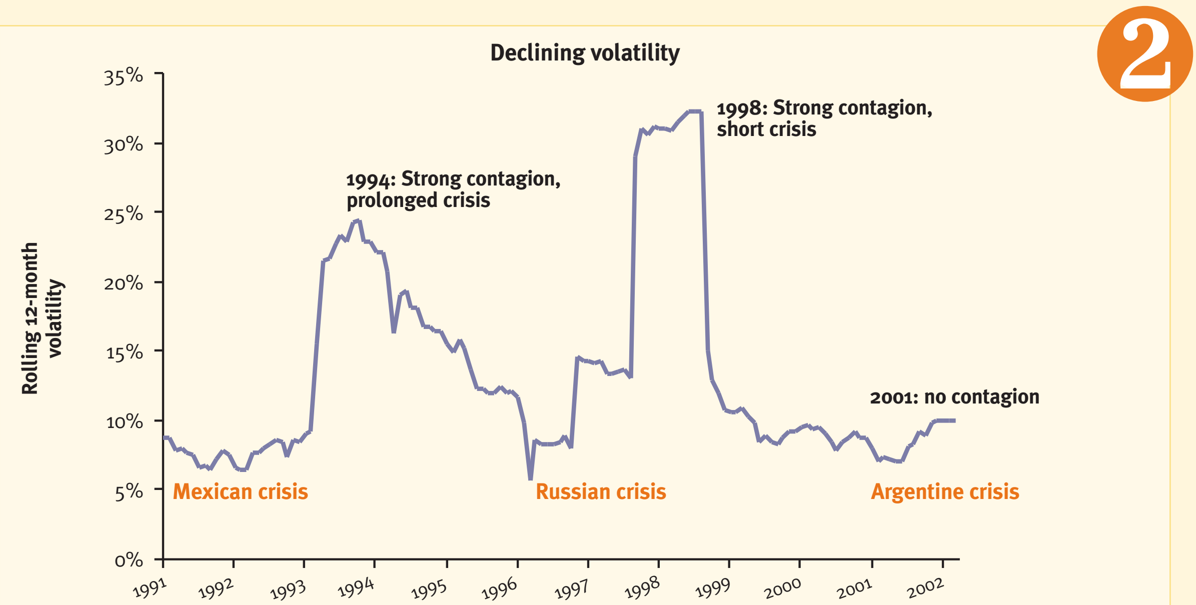
Christian Kopf, DWS Investments

equity investors have been better off investing a part of their US equity portfolio into emerging market debt to significantly decrease the overall risk and enhance the portfolio return. The optimal allocation of 48 per cent may be somewhat exaggerated, as the asset class would not be able to accommodate such large flows. But 10 per cent of a US equity portfolio should be sufficient, allowing investors to further diversify into other non-correlated performing assets such as gold or hedge funds. Euro-based investors should bear in mind that most emerging markets bonds are dollar-denominated. Their investment in emerging markets bond funds may therefore be subject to swings in the Euro-Dollar exchange rate.

Some sceptical investors, particularly those who had their fingers burned by tech stocks, may be suggesting



Source: DWS Investments



Source: DWS Investments

this is another over-hyped story and that after 10 years of good returns, the bust is just round the corner. We don't think so.

FAIR VALUE

The answer lies in examining market valuations. In the equity world, investors scrutinise the price/earnings ratio. Equities are cheap if it is low and expensive if it is high. For emerging markets, the key value indicator is the yield spread, which is the difference between the Treasury yield and the average yield of emerging market bonds.

If Treasury yields are 4 per cent, and emerging market bonds are yielding 10 per cent, the spread is 6 per cent or 600 basis points.

This spread is compensation for the default risk faced by investors in emerging markets. When the spread is high, the market is cheap. When the spread is low, it is expensive.

Prospective investors need to examine how spreads have evolved over time and how they stand today.

The EMBI spread, which started at 1100 basis points (bps) in 1991, is now at 650 bps. When bonds were yielding 23 per cent at the height of the Mexico crisis in 1994/95, the spread rose from 400 bps to 1500 bps, as Treasuries were yielding around 8 per cent.

As bond yields rise, prices goes down, according to the fundamental mathematical fixed income relationship. So when Russia went into default in 1998 and the market spread surged from 600 to 1500 bps, prices went down and investors lost money, although they still banked regular coupon payments.

The key lesson learnt by emerging market investors has been to buy bonds during these crises, when yields are at their highest and prices at their cheapest. High yields are always likely to fall, which leads to capital appreciation as prices recover.

The long-term average spread for emerging market bonds has been roughly 800 bps. So in spite of phenomenal returns over 10 years, investors can conclude from the current 650 bps spread, that the market is still fairly valued and not overly expensive. (See Chart 1.)

One of the greatest dangers for emerging markets investors is the "contagion effect", ie, the spill-over of a country crisis to other markets. During the Mexican crisis of 1994/95 and the Russian crisis of of 1998/99, the market as a whole sold off massively. A financial crisis in one country soon spread across the region and beyond. When Russia came under pressure, all countries issuing bonds in this asset class sold off.

But market behaviour has since changed and contagion risks are now deemed to be lower than previously. When Argentina's government went into default in 2001, investors holding Argentine bonds suffered, but holders of other emerging market bonds were not under pressure, as shown by the relatively low volatility of the asset class. (See Chart 2.)

Examining rolling 12-month standard deviations of total return, the Mexican and Russian crises led to huge contagion. The "Tequila crisis" led to 20 per cent volatility in emerging market bonds, while volatility at the peak of the Russian crisis reached 30 per cent. But Argentina's default led only to 7 per cent volatility. This means that in 2001, a country crisis has not spread over to the asset class as a whole. It is the sign of a mature market with mature institutions, whose dedicated emerging markets portfolio experts don't panic and sell everything when they are under pressure.

When a country reschedules debt, as Ukraine did after suffering a steep economic decline after the break-up of the Soviet Union, old bonds are converted into new ones, with the agreement of investors.

This can result in a "haircut", involving a reduction in the principal or interest rate. Bondholders must take a loss in these cases, but they are compensated for the risk of a loss by a higher yield in the first instance.

If a central scenario suggests that spreads are on their way down, then prices will go up, and fund managers are likely to favour these countries

Key strategies

There are three key strategies available to private investors interested in emerging market bonds:

- **Investing directly in individual bonds of countries, such as Argentina or Ukraine. This leads to concentrated default risk and requires close monitoring of macroeconomic and political risk**
- **Counter-cyclical investment. Going into the asset class at the height of a crisis is the best strategy, as the potential for yields to fall and prices to rise is very high. The investors can then sell when the spreads narrow, but correct timing is essential.**
- **Strategic allocation in emerging market funds offering a portfolio of 20-30 issuers, which spread the risk if one country slides into default. This is an excellent tool to diversify the overall portfolio of a high net worth individual. Currently, funds benchmarked against the EMBI Global index hold nearly 50 per cent in Latin American bonds, 20 per cent in Eastern Europe and in Asia, and roughly 10 per cent in the Middle East and Africa.**

PROCESS

A robust investment process for emerging markets bonds should start with a study of the fundamental outlook for the asset class before analysing scenarios for the best, worst and central cases for each country's bonds, based on macroeconomic and political factors. Probabilities can then be assigned to each scenario, the expected return and risk can be computed, and the fund manager can then choose the countries with the best combination of both. If a central scenario suggests that spreads are on their way down, then prices will go up, and fund managers are likely to favour these countries.

The debt of many countries, including Chile, Mexico, Croatia, South Africa and Poland, is maturing out of the emerging markets asset class. But there is no shortage of investment opportunities. Some Latin American countries such as El Salvador have returned to the capital market, while others such as Bosnia and Serbia are likely to be issuing bonds in the future.

Christian Kopf, vice president, international fixed income, DWS Investments